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No. 98-_____

In the
Supreme Court of the United States
October Term 1998

Robert D. Potts,

Petitioner,

v.

Securities and Exchange Commission,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF
APPEALS FOR THE EIGHTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

This Court has never addressed the standards that govern the sanctions the Securities and Exchange Commission (Commission) imposes on professionals, such as accountants, who practice before it. In this case, the Commission sanctioned an accountant whose only role was to serve as concurring, or reviewing, partner of an audit and whose responsibility was limited solely to providing additional assurance that the audit met Generally Accepted Auditing Standards (GAAS) and the financial statements conformed to Generally Accepted Accounting Principles. The Commission, which had never expressly addressed the conduct of a concurring partner *qua* concurring partner, determined to punish the accountant under Rule 2(e)(1)(ii) of the Commission for improper professional conduct because he failed to exercise the due care standard required generally of auditors under GAAS. The Commission imposed its sanction even though the accountant's conduct complied with existing standards of the industry and his firm for concurring partner review, and the Commission itself had never articulated any such standards.

I. Whether the Due Process Clause of the Fifth Amendment precludes the Commission from imposing sanctions for unprofessional conduct when the sanctioned conduct complies with existing professional standards and the Commission has not articulated a contrary standard.

II. Whether the securities laws authorize the Commission to impose sanctions for unprofessional conduct when the sanctioned conduct complies with existing professional standards and the Commission has not articulated a contrary standard.

RULE 29 STATEMENT

No disclosure is required under Sup. Ct. R. 29.6.

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Petitioner Robert D. Potts seeks a writ of certiorari to review the judgment of the United States Court of Appeals for the Eighth Circuit.

OPINIONS BELOW

The opinion of the Eighth Circuit is reported at 151 F.3d 810 (8th Cir. 1998) (A-1–A-7.) The decision of the Securities and Exchange Commission (Commission), which the Eighth Circuit affirmed, is unreported. *In re Robert D. Potts*, Accounting and Auditing Release No. 964, 7 FED. SEC. L. REP. (CCH) ¶ 74,479 (Sept. 24, 1997). (A-9–A-60.)

The Eighth Circuit issued its decision on August 4, 1998. Petitioner timely moved for rehearing and rehearing en banc, which the court denied on September 30, 1998. (A-8.)

JURISDICTION

Petitioner invokes the jurisdiction of this Court under 28 U.S.C. § 1254(1).

CONSTITUTIONAL AND ADMINISTRATIVE PROVISIONS INVOLVED

Constitutional Provision Involved.

The Due Process Clause of the Fifth Amendment reads:

"No person shall be ... deprived of life, liberty, or property, without due process of law;"

Administrative Provision Involved.

Rule 2(e) of the Commission provides as follows:

(e) *Suspension and disbarment.* (1) *Generally.* The Commission may censure a person or deny,

temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the Commission after notice and opportunity for hearing in the matter:

> (i) Not to possess the requisite qualifications to represent others; or
>
> (ii) To be lacking in character or integrity or to have engaged in unethical or improper professional conduct; or
>
> (iii) To have willfully violated, or willfully aided and abetted the violation of any provision of the Federal securities laws or the rules and regulations thereunder.

17 C.F.R. § 201.102(e) (1997).[1]

STATEMENT OF THE CASE

In September 1997, the Commission sanctioned Robert D. Potts for improper professional conduct under Rule 2(e)(1)(ii) in connection with his work as concurring partner on the audits of the 1988 and 1989 financial statements of Kahler Corporation (Kahler). (A-61.) Mr. Potts had been a certified public accountant since 1967 and was, until the Commission initiated these proceedings against him, the managing partner of the Minneapolis office of Touche Ross & Co. and its successor, Deloitte & Touche. (J.A. 495-96.)[2]

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[1] The SEC recodified its Rules of Practice in 1996. Rule 2(e) was renumbered Rule 102(e), but no substantive changes were made to the rule. (A-11 n.2.) Consistent with the decision below, petitioner will simply refer to the applicable rule as Rule 2(e).

[2] The abbreviation "J.A." refers to the Joint Appendix in the court of appeals.

Standards For Concurring Partner Review.

Under S.E.C. Rule 12g-4(a)(1), companies with more than 500 shareholders must periodically file with the Commission reports that include their audited financial statements. The Commission requires that the accounting firms which perform the audits of the financial statements in these reports certify that their audits have been conducted in accordance with Generally Accepted Auditing Standards (GAAS). Regulation S-X, 17 C.F.R. § 210.2-02(b) (1997). The opinions of Touche at issue stated that the firm had examined Kahler's financial statements for 1988 and 1989 in accordance with GAAS and that, in the opinion of Touche, the financial statements of Kahler were fairly presented in conformity with Generally Accepted Accounting Principles (GAAP). (J.A. 66-67.)[3]

Concurring partner review is part of the accounting profession's quality assurance efforts. It consists primarily of a second look at selected audit work papers by an experienced accountant to see that the important accounting issues have been addressed. The role of the concurring partner is very limited – to provide additional assurance that the audit has been conducted according to GAAS and the financial statements conform to GAAP.

There are, even today, no Commission rules or regulations on concurring partner review. As the Commission conceded in this case, it had never before addressed in a Rule 2(e) proceeding the role of an accountant who had functioned solely as a concurring partner. (A-35.) The primary industry guidelines, GAAP or GAAS, were also silent on concurring partner review. However, the American

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[3] For a discussion of the meaning of GAAP and GAAS, *see Checkosky v. S.E.C.*, 23 F.3d 452, 472-73 (D.C. Cir. 1994); *see also Godchaux v. Conveying Techniques, Inc.*, 846 F.2d 306, 315 (5th Cir. 1988) (discussing accountant's flexibility in applying GAAP).

Institute of Certified Public Accountants (AICPA), which develops the audit standards known as GAAS, had through its S.E.C. Practice Section issued guidelines for a concurring review. These guidelines, which were quite general, stated that a concurring review involved:

> [R]eading the financial statements and the firm's report thereon and making an objective review of significant accounting, auditing, or reporting considerations. Such review should be performed prior to the release of the report and should include discussions with the partner in charge of the engagement and review of selected working papers.

(J.A. 1179.)

Under the guidelines of the AICPA S.E.C. Practice Section, individual firms were encouraged to adopt more specific guidance, which Touche did. The firm's policies provided as follows:

> All S.E.C. engagements must be reviewed by a preassigned concurring partner reviewer (CPR) who meets the criteria described later in this section. This review is to include the procedures described in Section 15.400 and a review of the following working papers:
>
> - Top memorandums
> - EC-1A, Audit Engagement Management Checklist
> - EC-2, Report Disclosures Checklist

- Appropriate EC Series for S.E.C. Compliance and Procedures; for example, EC-3A, EC-3B, etc., and,

- Review of working papers relevant to significant accounting, auditing or reporting considerations to the extent deemed necessary by the reviewer.

(J.A. 1267.)

The extent of work paper review was left to the concurring partner's professional judgment. (J.A. 616.) A concurring partner review was *not* to be an "audit of the auditors" because it would be impractical to repeat either the inquiries that the engagement team had made of management or the detailed review procedures that the audit staff had performed. (J.A. 617.) Indeed, Touche's policies provided that "the PSR [concurring partner] will not assume the responsibility or duties of the engagement partner or staff." (J.A. 1265.)

The Touche Audits of Kahler and Mr. Potts' Role as Concurring Partner.

Touche performed its audit of the 1988 and 1989 Kahler financial statements through its customary engagement team approach. The leader of the team was the engagement partner assigned to the audit; under him was an audit manager, who supervised the work of accounting staff. (J.A. 1248-49.) After the audit work had been completed, but before the firm issued its opinion, Touche required a concurring partner review to provide the additional assurance called for in the guidelines of the AICPA S.E.C. Practice Section. (J.A. 1178-79, 1265.) Consistent with industry practice, however, Touche required that the engagement partner retain full and final responsibility for all audit decisions. (J.A. 618, 1264.)

This case turned on a single aspect of Kahler's 1988 and 1989 financial statements. In 1988 Kahler decided to sell a hotel property, called University Park, that it owned in Salt Lake City. (J.A. 762.) Kahler incurred operating losses while trying to sell the hotel, and the company elected to defer the operating losses rather than deducting them against current income. To defer the losses, Kahler had to satisfy the requirements of Accounting Principles Bulletin No. 30 (APB 30), as further interpreted by Emerging Issues Task Force Issues Nos. 85-36 and 84-28. (J.A. 636-38.) While APB 30 required the company to have a formal plan of disposition, APB 30 did not require that the plan be in writing or included in audit work papers. In addition, Kahler had to have a reasonable expectation of a profit on the sale, after taking into account the deferred losses. It was undisputed that APB 30 is both complex and difficult to understand and that experienced accountants could differ as to the meaning and application of APB 30. (J.A. 440-42, 449.)

During the audit of the 1988 financial statements, Mr. Potts learned from the engagement partner that Kahler had engaged an investment firm to sell a partial interest in the hotel. To qualify for APB 30 treatment, Kahler had to sell its entire interest in the hotel. Consequently, Mr. Potts suggested to the engagement partner that they meet with Kahler management. (J.A. 510-11.) At that meeting, Mr. Potts and the engagement partner heard the chairman of Kahler state that the company was committed to selling its full interest in the hotel and that the retention of the investment firm was merely a way to generate interest in the property. (J.A. 514-16.)

Nevertheless, Mr. Potts concluded that more audit work was needed to verify that Kahler was committed to selling its entire interest in the hotel. (J.A. 516-17.) Mr. Potts suggested that the engagement partner meet with the Kahler audit committee, which was composed of board members independent of Kahler management. After the engagement

partner held a lengthy meeting with that committee, he reported back to Mr. Potts that the audit committee was aware of the requirements of APB 30, that the company had a plan in place to dispose of the property, and that the company met the requirements of APB 30. (J.A. 517-18.) The audit committee reported this decision to the full board, which was recorded in board minutes that Mr. Potts subsequently reviewed. (J.A. 522.) Having raised the issue with the engagement partner, Mr. Potts concluded that the engagement team had adequately determined that, for 1988, Kahler had properly accounted for the hotel as an asset held for sale.

In late December 1989, Kahler reclassified University Park as an operating property. (J.A. 1621-22, 1629.) This change raised the question of whether APB 30 applied to operating losses in 1989. The Touche engagement team consulted with the staff of experts at the firm's National Office in New York City to resolve the question over the applicability of APB 30 to University Park operating losses for 1989. (J.A. 542, 573c-73d, 575-78.) The engagement partner informed Mr. Potts that the audit team had been working with the National Office to determine the proper accounting treatment for the hotel. In consultation with the National Office, the Touche audit team had Kahler draft a footnote to its 1989 financial statements that disclosed what University Park depreciation and amortization expenses Kahler had deferred in 1989. (J.A. 575-77, 583.) Mr. Potts reviewed the appropriate audit work papers for the 1989 audit and concluded that in his professional judgment his review of working papers did not disclose any issue that had not been resolved in consultation with Touche's National Office. (J.A. 545, 569a.)

The Commission's Sanction.

On March 18, 1993, the Commission issued an order charging Mr. Potts with improper professional conduct based

on alleged violations of GAAP and GAAS in the 1988 and 1989 audits of Kahler. (J.A. 30-38.) The charges related solely to the accounting treatment Kahler gave to University Park operating losses in those two years. (J.A. 36.) The charge did not squarely assert whether the sanction being sought was premised on scienter or merely on negligence. Following an evidentiary hearing, an administrative law judge ruled against Mr. Potts, recommending a two-year suspension from practice before the Commission. (J.A. 68-131.)

On review, the Commission affirmed the decision, although it reduced the suspension to nine months. The Commission attempted to side-step one key issue – whether scienter had to be shown before a Rule 2(e) sanction could be imposed – stating that it did not need to resolve that question because, in its view, Mr. Potts had acted recklessly. (A-31, A-32 n.44.) The Commission premised its scienter finding on what it claimed were three miscues by the engagement team, which it felt Mr. Potts should have caught as concurring partner. According to the Commission, he should have: (1) required evidence of a *written* plan to sell the hotel; (2) required evidence of an *independent* appraisal of the hotel; and (3) not allowed Kahler a full year's deferral of operating losses in 1988, which the Commission concluded was problematic. (A-19.)

While admitting "that the matter represents the first litigated proceeding to come before us involving an accountant acting solely as a concurring partner," (A-35), the Commission nevertheless rejected Mr. Potts' argument that the Commission's previously unannounced standards for concurring partner review were unconstitutionally vague and ambiguous. The agency instead asserted that existing precedent addressed the responsibilities of concurring partners. (A-35–A-38.) In any case, the Commission believed that an accountant's duty to exercise due care under GAAS had been violated, and that alone was sufficient to

constitute improper professional conduct. (A-21–A-23, A-31.)

Commissioner Wallman expressed a strong dissent with "the majority's decision that Mr. Potts was reckless." (A-60.) He identified the primary shortcoming of the majority's decision:

> The issue is what was a concurring partner on an engagement in 1988 and 1989 supposed to be doing in the context of this kind of audit for the Kahler Corporation being run by a presumably competent engagement partner in one of the nation's respected accounting firms. Specifically, what is unclear and controverted is what precisely were the then obligations of the concurring partner -- not the engagement partner -- in concurring with respect to an audit. The majority cannot say what they were, because there is no answer in the record.

(A-58.)

The Court of Appeals' Affirmance.

On appeal, the AICPA – the leading national organization of accountants and author of the only industry standard on concurring partner review – filed a brief *amicus curiae* in support of Mr. Potts. The interest of the AICPA as *amicus* arose from the organization's concerns over the Commission's confusion of its S.E.C. Practice Section guidelines with GAAS, the agency's incorrect determination of a concurring partner's duties under the S.E.C. Practice Section guidelines, and the agency's unsupported conclusion that Mr. Potts posed a threat to Commission processes. The AICPA wrote:

> Each of these conclusions has serious ramifications for the proper implementation of both GAAS and the S.E.C.PS guidelines. The S.E.C.'s misapplication of the concurring review requirement both overburdens the reviewing partners' role and dilutes accountability for the audit report. It will prohibitively raise costs by requiring, in essence, two partners-in-charge, and sow confusion as to the nature and required depth of a concurring review. The interpretations laid on the concurring review requirement by the S.E.C. are thus not only erroneous but counterproductive.

Brief of AICPA in Court of Appeals at 3-4.

The Eighth Circuit nevertheless affirmed the Commission, concluding that the Commission's finding of reckless professional conduct was supported by substantial evidence. (A-5–A-6.) The court viewed Kahler's treatment of University Park as suspect on two points, whether the company intended to sell all of its interest in the asset and whether the company could realize a profit on the sale. Mr. Potts' failing, in the view of the circuit court, was that he relied on the engagement partner (and his representations) for resolution of the accounting questions regarding the application of APB 30 to sale of the hotel. According to the court, Mr. Potts failed to test and probe those representations, an oversight that "amounted to 'an egregious refusal to see the obvious, or to investigate the doubtful . . . .'" (A-5, quoting *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1426 (9th Cir. 1994)). The court was also troubled by the allowance of a full year's deferral of Kahler's operating losses for the hotel in 1988.

The appellate court went on to reject Mr. Potts' argument that his due process rights were violated for lack of adequate notice of the standards of conduct expected of a reviewing partner. Looking to auditing standards, the court observed

that an auditor must have appropriate professional skepticism, must extend the audit when there is reason to suspect a material misstatement, and must have a reasonable basis for the audit opinion. (A-5.) While the court stated that the concurring partner is not expected to "do the audit all over again," he had to observe due care in applying these auditing standards, which the Commission had used to justify its sanction of Mr. Potts. (A-6–A-7.) In addition, the court concluded that in prior decisions the Commission had established that a concurring partner had to detect violations of GAAS and GAAP, which should have provided Mr. Potts a basis for determining the conduct expected of him. (A-7.) The court simply rejected out-of-hand the AICPA's submission and the organization's explanation that Mr. Potts' conduct complied entirely with existing industry standards. (A-7.)

REASONS FOR GRANTING THE WRIT

This case raises fundamental, important and recurring questions about the scope of the Commission's authority to impose sanctions for "improper professional conduct." Although this Court has emphasized the gravity of the standards governing the imposition of sanctions by various professional regulatory bodies (such as bar associations), it never has addressed the scope and contours of the Commission's authority to impose profession-crippling sanctions for what the agency deems to be "improper professional conduct." The issue is ripe for review and squarely presented by this case.

The Commission premised its sanction of Mr. Potts on its finding of a breach of the duty of due care required under GAAS – standards accountants are to follow when performing audits. Nothing in GAAS tells accountants who are acting as concurring partners what they should do. To address this gap, the AICPA, the leading professional

organization, and individual firms have developed standards – standards that Mr. Potts met in this case.

By its decision, the Commission reflected a view of the concurring partner function that differs greatly from what the industry, Touche and Mr. Potts understood it to mean in 1989 and 1990, when the Kahler audits were performed. The industry, Touche and Mr. Potts believed his limited review was merely to provide additional assurance that the audit had addressed the critical issues. Now, years later, the Commission has held that Mr. Potts should have probed and tested the conclusions of the engagement partner; that is, "audit the audit."

The requirement to exercise due care has meaning only when measured against a known duty. There were existing guidelines for Mr. Potts to follow in 1989 and 1990, and no one disputes that Mr. Potts met those guidelines. What the Commission now expects of him is something totally new and not a standard of conduct divinable from earlier Commission precedent.

Neither Mr. Potts nor anyone else in the industry would have expected that the role of the concurring partner meant what the Commission now says it means. This paradigm shift in the role of the concurring partner is a fundamental change in the audit process. To sanction Mr. Potts for violating the new role is to ignore the limits the Due Process Clause and the securities laws impose on the Commission – Mr. Potts could not have gleaned from Commission rules or precedent the sweeping scope of this new role.

The Commission requires many thousands of companies to file reports with the agency, including the audited financial statements of those companies. Under GAAS – drafted by the AICPA and *not* the Commission – final authority for audit decisions has been purposefully left with one person, the engagement partner. With this decision, however, the Commission has rewritten basic auditing standards and rejected long-standing industry practice. The case affects

how these accounting firms will perform audits, and especially affects the accountants who perform concurring reviews. Thus, the agency's sanction in this case, for conduct it had not previously addressed and for conduct that complied with industry and Touche standards, is a textbook example of the need for clarity regarding the scope of an agency's authority in this important area.

I. THE COMMISSION'S SANCTION UNDER RULE 2(e)(1)(ii) FOR IMPROPER PROFESSIONAL CONDUCT RAISES IMPORTANT DUE PROCESS ISSUES.

Under the Fifth Amendment, the federal government cannot take away a fundamental right of any citizen, including a property or liberty interest, without due process of law. *See Paul v. Davis*, 424 U.S. 693, 710-11 (1976). An accountant's right to practice before the Commission is a property interest protected by the Due Process Clause. *See In re Ming*, 469 F.2d 1352, 1355 (7th Cir. 1972) (right to practice law). Likewise, an accountant's good name and reputation, also in peril here, is a liberty interest protected by the Due Process Clause. *Cf. Fitzgerald v. Mountain Laurel Racing, Inc.*, 607 F.2d 589, 593, 602 (3d Cir. 1979) (harness driver accused of inconsistent driving had reputation affected). The Commission and the court of appeals gave short shrift to these arguments.

A. The Court on Numerous Occasions Has Addressed how a Professional can be Regulated.

In a case involving the regulation of the legal profession, this Court reversed the disbarment of an attorney for lack of notice that use of a chaser to solicit business would lead to his disbarment. *In re Ruffalo*, 390 U.S. 544 (1968). The attorney had been charged with 12 counts of misconduct. In the disciplinary hearings that followed, evidence emerged that led

to another charge being added to those previously assessed against him. The adding of the final count based on evidence presented at the hearing led the Court to reverse his disbarment. The Court held that the "absence of fair notice as to the reach of the grievance procedure and the precise nature of the charges" violated the attorney's right to due process. 390 U.S. at 552; *see also Zauderer v. Office of Disciplinary Counsel of Supreme Court of Ohio*, 471 U.S. 626 654-55 (1985) (addressing claim that shift in theory relied upon to discipline attorney violated due process).

The Court in *Ruffalo* also stated, "How the charge would have been met had it been originally included ... no one knows." 390 U.S. at 551. This observation is crucial here. The Commission's initial charge was for improper professional conduct, which the Commission believed could rest on a single negligent act. Had the Commission made clear from the beginning this was solely a scienter case, Mr. Potts could have proceeded differently. Defending a scienter charge is materially different, especially if the sanction is truly premised on a threat to future Commission processes.

The Court has also seen fit on numerous occasions to address issues that arise when a governmental agency seeks to discipline a professional. The importance of a professional's right to practice was recognized in *Gibson v. Berryhill*, 411 U.S. 564 (1973), in which the Court struck down a state agency rule that prohibited optometrists from practicing as employees of another. The organization and means by which professionals market their practices has also drawn the attention of the Court on several occasions. Lawyers, for example, may employ truthful advertising about the prices of their legal services, *Bates v. State Bar of Arizona*, 433 U.S. 350 (1977), but may be precluded from in-person solicitation of business. *Ohralik v. Ohio State Bar Ass'n*, 436 U.S. 447 (1978). Similarly, the Court has addressed whether optometrists can market under trade names, concluding that

the state can limit such a practice. *See Friedman v. Rogers*, 440 U.S. 1 (1979).

This case raises issues of similar significance to the accounting profession. The Commission's use of Rule 2(e) to police the accounting profession is a draconian tool that, if sanctions are imposed, can effectively mean the end of an accountant's professional career. *See* Henry J. Friendly, *Some Kind of Hearing*, 123 U. PA. L. REV. 1267, 1297 (1975). As one judge rejecting a Rule 2(e) sanction observed:

> Given the enormous impact on accountants -- and lawyers -- that the Rule has, and in fairness to petitioners, the Commission must be precise in declaring the standard against which petitioners' conduct is measured and exactly why that conduct violated the standard.

Checkosky v. S.E.C., 23 F.3d 452, 462 (D.C. Cir. 1994) (Silberman, J.). Despite this admonition in *Checkosky*, in this case the Commission applied an ill-defined Commission rule to a vague accounting role to sanction Mr. Potts. The end result is a vague standard devoid of written guidelines and subject to selective and arbitrary enforcement.

B. No Concurring Partner Could Have Found Fair Warning of the Expanded Role the Commission has Imposed on Concurring Partners.

In 1989 and 1990, when he was serving as concurring partner of the Kahler audits, all Mr. Potts could have turned to for guidance as to his role as concurring partner were the guidelines of the AICPA S.E.C. Practice Section and Touche. *See supra* at 3-4; Brief of AICPA in Court of Appeals at 6. There is no question in this case that Mr. Potts complied with the only guidance available to him on the role of the concurring partner. In the face of this, the Commission could

only assert that in a *few* of its prior decisions it had mentioned errors made by concurring partners. This assertion ignores the Commission's own admission that this case is the first to deal with a concurring partner serving solely in that role. Moreover, that assertion is erroneous on its face, for none of the precedent the Commission cites imposed GAAS rules, written for the engagement team to follow, on a concurring partner. The Eighth Circuit's acceptance of the Commission's position, and its bald rejection of the views of the AICPA on this matter, underscore the need for this Court to review the requirement of constitutionally fair notice before Rule 2(e) sanctions can be imposed.

The primary case cited by the Commission was *Lester Witte & Co.*, Exchange Act. Release No. 34-17423, [1937-1982 Accounting Series Releases Transfer Bind.] FED. SEC. L. REP. (CCH) ¶ 72,307 (Jan. 7, 1981). In *Lester Witte*, the accounting firm failed to uncover overstatements of receivables and inventories – routine accounting matters not involving judgments of the type the Touche engagement team had to make in this case. The Commission did not charge the concurring partner with misconduct, nor did it discuss the AICPA S.E.C. Practice Section's guidelines (in place since 1978) or any aspect of GAAS governing the performance expected of the concurring partner. *Id.* at 62,866.

Another Rule 2(e) proceeding the Commission cited was *Stephen O. Wade*, Exchange Act Rel. No. 34-21095, [1982-87 AAER Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 73,432 (June 25, 1984). In *Wade*, the accountant held the position of Director of Audit and Accounting, an in-house consulting position that was *not* a concurring partner function; rather the role was to provide expertise to the audit team, as Touche's National Office did on the 1989 Kahler audit. Consequently, *Wade* offered no meaningful guidance to Mr. Potts on the limited role a concurring partner was to perform.

A third case the S.E.C. cited was *S.E.C. v. Grant Thornton*, AAER No. 118, [1982-87 Accounting and

Auditing Enforcement Releases Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 73,518 (Oct. 16, 1986). In *Grant Thornton*, the Commission charged the firm and the individual accountants with violating § 17(a) of the Securities Act and § 10(b) of the Exchange Act by participating in fraudulent transactions. This case had nothing to do with the standards applicable to a concurring review and was not even brought under Rule 2(e).

The Commission also cited *In re Kutz*, AAER No. 127, [1982-87 Accounting and Auditing Enforcement Releases Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 73,527 (Jan. 28, 1987), which involved an accountant who was concurring partner in name only. He personally planned the audits and physically visited a subsidiary's headquarters to review audit field work relating to overstated inventories. During the course of his audit work, Kutz ignored both an admonition from his firm's National Office to perform additional work and a disclaimer from the engagement partner (who refused to sign the audit opinion). Thus, the *Kutz* decision was neither analogous nor instructive as to the limited role intended by AICPA or Touche policies for concurring partners.

Finally, in a case that the Commission raised only on appeal, the concurring partner was charged under Rule 2(e) because he overstepped his limited role and served as "the primary contact" with the company's top management. *In re Seidman & Seidman*, Securities Act Release No. 6606, [1982-87 Accounting and Auditing Enforcement Releases Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 73,478, at 63,280 (Oct. 10, 1985). Consequently, the concurring partner lacked the objectivity needed to review what the audit team had done. Of particular interest in *Seidman* also was the Commission's observation that the concurring partner "diluted" the engagement partner's role by remaining the primary client contact. *Id.* The *Seidman* decision, if anything, supports the position that the limited review Mr. Potts performed was the proper level of involvement.

The Commission concluded that Mr. Potts violated Rule 2(e) because he failed to exercise the due care expected under GAAS of an accountant when auditing a firm. In this context, the term due care is so all-encompassing as to be devoid of practical significance. Rather, the term has to be defined against some known duty. All the Commission could say was that the cases relied on below were sufficient to give an accountant "broad" notice of what that duty was. Nowhere in the decisional law the Commission cited as merely illustrative of what was expected of Mr. Potts did it discuss the probing and testing it now claims Mr. Potts should have done. None of these cases applied GAAS against an accountant who performed only a concurring review to justify a career-ending sanction for missing errors in the audit. The "broad" notice the Commission says existed when Mr. Potts did his work was neither fair nor constitutionally sufficient notice.

C. The Commission Still Lacks a Consistent Approach to Applying Rule 2(e).

What the Commission says about its concurring partner precedents indicates the confusion within the ageney concerning what constitutes the fair notice required under the Due Process Clause before Rule 2(e) sanctions can be imposed. But the Commission's confusion over Rule 2(e) goes beyond its understanding of what concurring partners were supposed to have known in 1989 or 1990 concerning the scope of their duties. The agency, even today, cannot articulate a consistent standard of culpability or give meaningful content to what it means by "improper professional conduct."

The Commission's inability to define the standard of culpability that must be shown in Rule 2(e) proceedings – an inability presented in stark terms here – is exemplified by its decision in *Checkosky*. That case involved Rule 2(e)(1)(ii) charges against the accountants who had audited Savin

Corporation. Significantly, no concurring partner was ever charged in that case. The accounting treatment at issue in *Checkosky* was whether Savin could properly defer certain development costs rather than having to deduct them as current expenses. The Commission held the auditors had improperly allowed deferral of those costs, despite certain indicia of problems that can only be characterized as far more egregious than the "red flags" Mr. Potts is said to have missed. *Checkosky v. S.E.C.*, 23 F.3d 473, 475-78. (D.C. Cir. 1994).

On the first trip to the D.C. Circuit, the Commission argued variously that the accountants were guilty of scienter, but in any case, mere negligence sufficed to prove a Rule 2(e) violation. *Id.* at 459, 480-81. The D.C. Circuit disagreed and remanded the case "for a more adequate explanation of its interpretation of Rule (2)(e)(1)(ii)." *Id.* at 454. Following remand, the Commission reaffirmed its Rule 2(e) sanction, again on the ground the accountants had acted with scienter and, in any case, negligence alone was a sufficient basis for a Rule 2(e) sanction. *In re Checkosky*, 1997 WL 18303 (S.E.C. Jan. 21, 1997). On a second appeal to the D.C. Circuit, the Commission abandoned scienter as a basis for a sanction and argued mere negligence was enough. *Checkosky v. S.E.C.*, 139 F.3d 221, 223 (D.C. Cir. 1998) The D.C. Circuit disagreed and remanded the case with instructions to dismiss the charges. *Id.* at 226.

In addition to highlighting the Commission's fundamental confusion about Rule 2(e), the *Checkosky* decision highlights the issues presented here for still another reason. What the Commission did in *Checkosky* cannot be reconciled with what the Commission did in this case. In *Checkosky*, the Commission abandoned a scienter finding against two accountants, one an engagement partner who had direct audit responsibilities to ensure that the financial statements complied with GAAP. By any measure, the involvement of the accountants and their culpability was far greater. Here, in

contrast, the Commission adhered to its scienter determination against an accountant who was not part of the audit team and who had done what he had been directed to do to meet the duties imposed on him by his firm and the AICPA. The Commission simply cannot justify the difference in result between *Checkosky* and this case.

After its loss in the D.C. Circuit, the Commission tried to clarify matters with a rulemaking proceeding. Securities Act Release No. 7593, 63 Fed. Reg. 57,164 (1998). The Commission claimed that its amended rule was aimed at the purpose of deterring future harm to Commission processes, and thus, repeated acts of negligence or scienter would be required. *Id.* at 57,166. Commissioner Johnson dissented, stating that the rule as amended nevertheless allowed punishment for a single act of negligence. *Id.* at 57,178. The Commission's rulemaking did not resolve the issue raised in this case – what constitutes fair notice to an accountant before Rule 2(e) sanctions can be applied. That critical question remains opens and should be addressed by this Court.

The Commission's confusion in imposing disciplinary sanctions is also evident in *Upton v. S.E.C.*, 75 F.3d 92 (2d Cir. 1996). In *Upton* the Commission punished a manager in a brokerage firm for failing to supervise adequately a subordinate who had aided and abetted a violation of Rule 15c3-3(e). The Commission used that case to change how the brokerage industry was using customer securities to obtain working capital. In vacating the Commission's decision, the Second Circuit held that due process requires that "'laws give the person of ordinary intelligence a reasonable opportunity to know what is prohibited.'" *Id.* at 98 (quoting *Grayned v. City of Rockford*, 408 U.S. 104, 108 (1972)). The court stated that it could not defer to the Commission's interpretation of its rules "if doing so would penalize an individual who has not received fair notice of a regulatory violation." *Id.* Thus, the Eighth Circuit's finding of adequate notice in the

circumstances presents a conflict with the Second Circuit's finding of inadequate notice in *Upton*.

Moreover, the Commission cannot explain why it has been far more deferential to attorneys than accountants in applying Rule 2(e), when in fact both accountants and attorneys play a crucial role in Commission compliance. In its seminal Rule 2(e) decision, *In re Carter*, 47 S.E.C. 471 (1981), two attorneys were charged with improper professional conduct for their roles in advising a company regarding Commission disclosure requirements and in preparing disclosures to be filed with the Commission. The agency held that sanctions in that case were not appropriate because

> certain concepts of proper ethical and professional conduct were not sufficiently developed, at the time of the conduct here at issue, to permit a finding that either respondent breached applicable ethical or professional standards.

The Commission went on to make its ruling in *Carter* prospective in application. *Id.* at 472.

While *Carter* involved charges of improper professional conduct levied against attorneys, the Commission's rationale in that case drew no distinction between attorneys and accountants. Nevertheless, the Commission has tried to limit *Carter* solely to attorneys. *See* Securities Act Release No. 33-6783, 53 Fed. Reg. 26,427, 26,431 (1981) (Rule 2(e) proceeding against attorneys only when an attorney's prior conduct "has already provided the basis" for a separate securities law violation). This distinction is highly artificial, for the attorney's role in securities law compliance may be paramount. *See* A. A. Sommer, Jr., *The Emerging Responsibilities Of The Securities Lawyer*, [1973-74 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,631, at 83,688 (Jan. 1974) (lawyers predominate in S.E.C. compliance except in

certifying the financial statements). Indeed, in the first *Checkosky* appeal, the appellate court asked the Commission to justify its distinction, 23 F.3d at 487, something the Commission did not (nor could it) do on remand. In this case, the Commission has ignored the due process limitation it recognized in *Carter*, for the same ambiguity in standards existed for concurring partners in 1989 as did for attorneys in 1981.

In short, the Commission's imposition of a Rule 2(e) sanction for concerning partner review – a subject on which the Commission had not issued any standards – arises in the broader context of enduring confusion regarding the standards and notice applicable to the agency's general disciplinary authority, confusion that has been emphasized by two other courts of appeals in setting aside the agency's sanctions. Review by this Court is necessary to resolve the uncertainties regarding this far-reaching authority of the Commission.

II. THE COMMISSION'S IMPOSITION OF SANCTIONS FOR "IMPROPER PROFESSIONAL CONDUCT" RAISES SERIOUS QUESTIONS REGARDING THE PERMISSIBLE SCOPE AND EXERCISE OF THE COMMISSION'S STATUTORY AUTHORITY.

A. The Commission Has no Express Authority to Regulate the Practice of Accounting.

This case also raises important issues regarding the scope and exercise of the Commission's statutory authority to impose sanctions for "improper professional conduct." The "S.E.C.'s authority does not extend to general regulation of the accounting profession . . . ." *S.E.C. v. Pros Int'l, Inc.*, 994 F.2d 767, 769 (10th Cir. 1993). When Congress first established the Securities and Exchange Commission, it considered – but rejected – the notion of authorizing the

Commission to regulate accountants. Hearings on S. 875 Before the Senate Comm. on Banking & Currency, 73rd Cong. 248 (1933); *see* Robert A. Downing and Richard L. Miller, Jr., *The Distortion and Misuse of Rule 2(e)*, 54 NOTRE DAME L. Rev. 774, 777 & n.19 (1979). The only specific authority Congress finally granted the Commission was expressly limited to defining accounting terms and prescribing the form by which required information is presented in financial statements. *See* Securities Exchange Act of 1934 § 13(b)(1), 15 U.S.C. § 78m(b)(1). In contrast, Congress has expressly granted other agencies the authority to regulate professional conduct directly. *See, e.g.*, 31 U.S.C. § 711(3) (General Accounting Office); 31 U.S.C. § 330 (Treasury Department); 35 U.S.C. §§ 31, 32 (Patent and Trademark Office).

B. The Commission Has Used This Case to Write New Auditing Standards Without Express Authority to Do So.

Despite these limitations on its statutory authority, the Commission has used this case to rewrite industry standards for concurring partner review. The Commission has now created a dual partner role, one to make initial decisions, the other to test and probe these decisions with professional skepticism. This change is no mere trifle, for the AICPA S.E.C. Practice Section Guidelines were carefully designed to reserve exclusively to the engagement partner final authority over audit decisions. Brief of AICPA in Court of Appeals at 3, 7. The AICPA's standard makes eminent good sense, for dividing responsibility increases the likelihood no one will take full responsibility. The result is a serious erosion of the authority of the engagement partner and increase in the cost of audits.

To avoid a career-ending Rule 2(e) sanction, a concurring partner must now essentially audit the audit. The court of

appeals denied that result, but that denial rings hollow when viewed against the errors Mr. Potts is said to have made and how he could have avoided them. The agency concedes that Mr. Potts identified the critical issues and took appropriate steps to ask the engagement partner to go further. (A-25–A-26.) The Commission, supported by the court of appeals, would have required that Mr. Potts also do the following:

> probe and test the engagement partner's determination that Kahler was committed to selling all of its interest in the hotel;
>
> direct the engagement partner to require Kahler to permit prospective buyers to talk to Touche auditors;
>
> require the engagement partner obtain additional written evidence of a formal plan of disposal;
>
> demand *independent* appraisal evidence of the hotel's value;
>
> reject the engagement partner's conclusion that minutes of the Kahler Audit Committee were adequate written support of Kahler's intent to sell its entire interest in the hotel;
>
> apply professional skepticism to the engagement partner's conclusion that Touche's Chicago office made errors in its valuation of the hotel;

(A-26–A-30.)

There is only one conclusion that can be drawn – the Commission has, without any statutory authority to do so, redefined the role of the concurring partner. Yet in 1989, nearly ten years earlier, there were no clear standards for a concurring partner to follow. Even today there are no clear standards. Nor can the Commission's decision here be reconciled with its decision in *Seidman*, where an accountant was sanctioned for stepping outside his role of concurring partner. The Commission cannot have it both ways – either the concurring partner must be limited to the review set forth in the AICPA S.E.C. Practice Section guidelines or that of his firm, or he will encroach into the previously exclusive responsibility of the engagement partner.

In prior decisions, the Court has held that express statutory language limits what may be implied. *See Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 175 (1994). Yet, in this case the Commission has pushed its implied powers to an extreme. The Commission has no express authority to regulate accountants or to determine auditing standards, either generally or on a case-by-case basis. To punish Mr. Potts, the Commission has used first, an implied power to adopt Rule 2(e), and then, an implied power to "adopt" new auditing standards through adjudicative proceedings. The Court has struck down such expansive use of implied powers before. *O'Melveny & Myers v. F.D.I.C.*, 512 U.S. 79, 88-89 (1994) (no federal common law of malpractice).

Given what this Court has said on other occasions on the importance of express statutory language in this area, the securities laws do not give the Commission *carte blanche* to regulate professional conduct. That is a matter properly left to the Congress or the states for investigation and enforcement. *Cf. United States ex rel. O'Keefe v. McDonnell Douglas Corp.* 135 F.3d 1252 (8th Cir. 1998)(rejecting Justice Department's claimed right to ignore state ethical rules). In elevating the concurring partner to a super-

engagement partner, the Commission assumed authority Congress expressly declined to give it. This arrogation of authority was contrary to law.

The Commission's overstepping of its statutory authority – by creating new auditing standards for concurring partners – has led to a singularly unfair result. There was no question that APB 30 was unclear and judgment was required to apply the principle properly. Mr. Potts was effectively drummed out of his profession, not because he failed to abide by a clear prohibition. Instead, he lost his professional livelihood because he allegedly failed to ask what the Commission now asserts were the right questions of another professional who, in turn, was interpreting an accounting principle that required the application of professional judgment.

C. The Commission's Use of This Case to Write New Auditing Standards is Outside the Purpose of Rule 2(e).

According to the Commission, the purpose of Rule 2(e) is to allow the agency to protect its processes from future harm. Here, however, it confused that purpose with a desire to make a new role for concurring partners.

As the Commission itself recognized in *Carter*, not every violation

> may be sufficient to justify invocation of the sanctions available under Rule 2(e). The violation must be of a character that threatens the integrity of the Commission's processes in the way that the activities of unqualified or unethical professionals do.

47 S.E.C. 471, 478 (1981). It is only the "significant failure to perform properly the professional's role" that "raises the spectre of a replication of that conduct with other clients." *Id.*

at 477; *cf. S.E.C. v. Arthur Young & Co.*, 590 F.2d 785, 788-89 (9th Cir. 1979) (refusal to enjoin accounting firm affirmed; firm discharged its professional obligations by complying with GAAS in good faith).

The sole basis for the Commission's conclusion that Mr. Pott's conduct posed a threat of future harm was the finding of "recklessness." This conclusion begs, rather than answers, the question. First, the threshold question of "reckless as to what standard" is left unanswered. Since the standard was unknown, the recklessness finding is virtually meaningless. Second, as discussed below, the conclusion of recklessness on these facts is itself a major redefinition of scienter. Third, as this Court noted in *Ruffalo*, defending scienter is not the same as defending negligence. If scienter had been charged initially, Mr. Potts could have responded differently.[4]

A threat to future Commission processes, however, cannot be found through the post hoc imposition of a previously unknown standard. A person's failure to comply with unknown standards says nothing about the likelihood that he person will not comply with articulated standards. The Commission's sanction here cannot be justified as a protection from future harm to Commission processes and thus exceeds the agency's statutory authority.

D. The Commission's Decision Sowed Confusion by Equating the Supposed Error of a Concurring Partner to Scienter.

The Commission's decision below raises another important issue regarding statutory authority. The decision below created confusion because it found scienter in circumstances wholly at odds with the decisions of other

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[4] Contrary to the assertion of the court of appeals (A-5), all petitioner conceded below was that proof of scienter *might* create a *presumption* of risk of future harm. Brief of Petitioner in Court of Appeals at 35.

circuit courts. Though the Commission cited settled law as to what scienter means, A. 31 n.40, both it and the circuit court effectively ignored that definition when finding innocent errors of judgment of a concurring partner to equate to scienter. In actions against accountants under Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), scienter cannot be established on the basis of an error of judgment or a misapplication of accounting principles. It is well settled that evidence that financial statements audited by an accountant are false, or that the accountant did not conduct an audit in accordance with GAAP and GAAS, is insufficient by itself to establish scienter. *See, e.g., Malone v. Microdyne Corp.*, 26 F.3d 471, 479 (4th Cir. 1994) ("'mere publication of inaccurate accounting figures, or a failure to follow GAAP, without more, does not establish scienter'") (quoting *Fine v. American Solar King Corp.*, 919 F.2d 290, 297 (5th Cir. 1990)); *Zucker v. Sasaki*, 963 F. Supp. 301, 307 (S.D.N.Y. 1997) (scienter only if "'no reasonable accountant would have made the same decisions'") (quoting *S.E.C. v. Price Waterhouse*, 797 F. Supp. 1217, 1240 (S.D.N.Y. 1992)). Moreover, audit errors, even many auditing errors, do not rise to the level of scienter. *Cf. Chill v. General Elec. Co.*, 101 F.3d 263, 269-270 (2d Cir. 1996) (allegations that GAAP had been violated and "red flags" ignored did not support inference of recklessness).

Viewed against these cases, the Commission and the court of appeals adopted a scienter standard that amounted to mere negligence, for there is no other way to explain this result, especially compared to *Checkosky*. Here, the accountant punished was not part of the audit team, had a role expressly limited by industry and firm standards and complied with these standards. No other accountant in such a position had ever been sanctioned.

The scope of the Commission's authority to regulate the practice of accounting remains unsettled by this case. The Commission has used this case to make new auditing

standards, authority Congress has not expressly given the agency. Its decision undercuts what is meant by recklessness when accountants audit companies and has left the accounting industry uncertain as to what a concurring partner should do or whether adherence to industry standards will protect an accountant from a career-ending sanction. Review is needed to resolve that confusion.

CONCLUSION

This case presents important and recurring issues involving the conduct of accountants who perform and review audits of the many companies that must report their financial statements to the Commission. The agency has rewritten auditing standards in a way that threatens the integrity of the audit process. With its decision, the Commission has left unsettled what a reviewing partner should do and, indeed, what any accountant must do to avoid a Commission sanction, for reliance on existing industry standards will no longer be sufficient. Petitioner therefore respectfully requests that the Court grant his petition for writ of certiorari to review the decision of the Eighth Circuit.

Respectfully submitted,

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UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 97-3710

Robert D. Potts,	*	
	*	
Petitioner,	*	
	*	
v.	*	Petition for Review of an
	*	Order of the Securities and
Securities and Exchange	*	Exchange Commission
Commission,	*	
	*	
Respondent.	*	
	*	
	*	
	*	
American Institute of	*	
Certified Public	*	
Accountants,	*	
	*	
Amicus Curiae.	*	

Submitted: June 8, 1998
Filed: August 4, 1998

Before FAGG, BRIGHT, and BEAM, Circuit Judges.

FAGG, Circuit Judge.

Robert D. Potts petitions for review of an order of the Securities and Exchange Commission (SEC or the Commission) sustaining the 1994 finding of an administrative law judge (ALJ) that Potts had engaged in improper professional conduct in violation of SEC Rule 2(e)(1). See 17 C.F.R. § 201.2(e)(1)(ii) (1993). The ALJ suspended Potts from practicing before the SEC for eighteen months, a period the SEC cut in half. Because substantial evidence supports the SEC's finding, and because Potts had ample notice of the standards governing his audit duties, we affirm.

On appeal, Potts challenges the SEC's ultimate finding of improper professional conduct. Potts does not, however, dispute the SEC's summary of the underlying facts, and our review of the administrative record has disclosed nothing inconsistent with that summary. We thus draw our statement of the facts from the SEC's thorough opinion. See In re Robert D. Potts, CPA, Accounting and Auditing Enforcement Release No. 964, 7 Fed. Sec. L. Rep. (CCH) ¶ 74,479 (Sept. 24, 1997). Potts was a partner at the accounting firm of Touche Ross and its successor Deloitte & Touche (Touche). He served as the concurring partner for the 1988 and 1989 audits of Kahler Corporation, which owns and manages hotels. This case centers on Kahler's accounting treatment of one of its properties, the University Park Hotel (the Hotel). Throughout 1988 and 1989, Kahler accounted for the Hotel as an asset held for sale. The Hotel lost money both years, but Kahler's accounting treatment allowed Kahler to capitalize those losses --that is, to factor them into the Hotel's carrying value rather than deducting them from current income. As a result, in 1988 Kahler posted a net gain instead of a million dollar-plus loss, and in 1989 a net loss of $1.8 million instead of $2.8 million. See id. ¶ 74,47D, at 63,597-63,599. According to a publication of the American Institute of

Certified Public Accountants (AICPA), the role of a concurring partner is to provide a second-level review and thus afford further assurance that the audited company's financial statements conform with generally accepted accounting principles (GAAP) and that the audit measures up to generally accepted auditing standards (GAAS). See id. ¶ 74,479, at 63,597 & n.1. Potts concurred both years in Touche's unqualified audit opinion of Kahler's financial statements. See id. ¶ 74,479, at 63,599.

Under GAAP, certain conditions must be met before a company may account for a property as an asset held for sale. Among other requirements, the company must to a formal plan to sell its entire interest in the property, and it must determine that the sale of the property will cancel out any unreported operating losses and result in a net gain. See id. ¶ 74,479, at 63,599-63,600. In light of these requirements, the SEC found Kahler's accounting treatment of the Hotel improper for four reasons. First, instead of pursuing an outright sale, Kahler repeatedly sought investors to share ownership of the Hotel with Kahler. Second, Kahler did not have a formal plan to sell the Hotel. Third, Kahler's management had no valid basis to conclude the Hotel's selling price would make up for its operating losses. Fourth, although Kahler's Board of Directors first authorized the sale of the Hotel--actually, of only an interest in the Hotel--in April 1988, Kahler backdated its treatment of the Hotel as an asset held for sale to the beginning of the year. See id.

The SEC found Potts's conduct as concurring partner on the Kahler audits seriously deficient in several respects. To begin, Potts approved the Kahler audits despite inadequately explained documentary evidence that Kahler did not intend to sell the Hotel outright. The 1988 file Potts reviewed allowed Kahler's Board of Directors had authorized the sale, not of the Hotel, but of an interest in the Hotel. Gregory Melsen, the lead partner for the Kahler audits, also showed Potts a

contract under which Kahler hired Piper, Jaffray & Hopwood to sell an interest in the Hotel. On Potts's suggestion, Melsen met with Kahler's internal audit committee, and afterwards Melsen assured Potts that Kahler was committed to a complete sale of the Hotel. Potts took Melsen's word for it without further investigation. As it turned out, Melsen was going on nothing more than the audit committee's say-so, without any supporting documentation negating or explaining the contrary evidence. The 1989 file also contained contradictory evidence of Kahler's intent to sell the Hotel, but Potts again concurred. See id. ¶ 74,479, at 63,602-63,603.

Further, Potts signed off on the Kahler audits despite signals that the Hotel was worth much less than Kahler said. For the 1988 audit, the Hotel's value was derived using invalid methods, as Potts himself acknowledged before the ALJ. For the next year's audit, Kenneth Riggs of Touche's Valuation Office pegged the Hotel's value at $11.4 million, far below its book value of $16.75 million. When the audit team received Riggs's analysis, it substituted Kahler's higher cash flow projections for the Hotel for Riggs's more conservative projections, which were based on past results, and it took another accounting measure that enhanced the Hotel's valuation. Melsen told Potts these changes were needed to correct errors in Riggs's analysis. Once again, Potts took Melsen's word for it, despite a document in the 1989 file identifying Kahler's aggressive attitude toward accounting as a main source of audit risk. See id. ¶ 174,479, at 63,603-63,604 & n.37. Finally, Potts concurred with Kahler's backdating of the Hotel's accounting treatment. The SEC called Potts's willingness to do so "inexplicable." Id. ¶ 74,479, at 63,604. For these reasons, and because of "the keen significance to [Kahler's] financial statements of [the Hotel's] loss deferrals," the SEC agreed with the ALJ's conclusion that Potts should be suspended for improper professional conduct because he had acted with reckless

disregard of his duties as an independent auditor. Id. ¶ 74,479, at 63,604-63,605.

Potts contends the record fails to sustain the SEC's finding of recklessness. That finding is conclusive if supported by substantial evidence on the record as a whole. See Everest Sec., Inc. v. SEC, 116 F.3d 1235, 1238 (8th Cir. 1997); 15 U.S.C. § 78y(a)(4)(1994). To be reckless, Potts's performance had to represent "an extreme departure from the standards of ordinary care, which present[ed] a danger of misleading buyers or sellers that [was] either known to [Potts] or [was] so obvious that [Potts] must have been aware of it." In re Potts, 7 Fed. Sec. L. Rep. (CCH) ¶ 74,479, at 63,604 n.40 (internal quotations omitted). Drawing on an opinion Potts himself cites, the question in this case is whether the record shows Potts's conduct amounted to "an egregious refusal to see the obvious, or to investigate the doubtful." In re Worlds of Wonder Sec. Litig., 35 F.3d 1407, 1426 (9th Cir. 1994) (internal quotations omitted). Kahler's accounting treatment of the Hotel mattered. In 1988 alone, it made all the difference between showing a profit instead of a loss. Despite this evident importance, and despite signals that Kahler's treatment of the Hotel was suspect in two different ways, Potts approved the audits based on Melsen's unprobed, untested representations. Most glaringly, Potts countenanced Kahler's backdating of the "asset held for sale" treatment to the start of 1988, even though he knew Kahler's Board did not approve any kind of sale until April of that year. From all this, reasonable people could conclude Potts's conduct was reckless. Potts acknowledges the SEC's authority to discipline him for reckless professional misconduct, so we need not address Potts's argument that negligence is insufficient to justify sanctions under SEC Rule 2(e)(1). Cf. Berdahl v. SEC, 572 F.2d 643, 647 (8th Cir. 1978). Similarly, because Potts concedes the Commission may presume a risk of future harm from reckless conduct, the nine-month

suspension imposed here was well within the SEC's broad discretion. See Everest, 116 F.3d at 1240.

Potts also contends his suspension violates his due process rights because he did not have adequate notice of the SEC's standards of professional conduct for concurring reviewers. See Stephenson v. Davenport Community Sch. Dist., 110 F.3d 1303, 1308 (8th Cir. 1997); Upton v. SEC, 75 F.3d 92, 98 (2d Cir. 1996). The SEC did not invent new standards in this case. On the contrary, the Commission evaluated Potts's conduct in light of the well-established norms of the accounting profession, collectively referred to as GAAP and GAAS. For example, an auditor's opinion must have a reasonable basis in sufficient evidence. See In re Potts, 7 Fed. Sec. L. Rep. (CCH) ¶ 74,479, at 63,606. An auditor must maintain "an appropriate level of professional skepticism." Id. ¶ 74,479, at 63,606. An auditor who has reason to suspect a material misstatement in the audited company's financial report must extend his or her audit accordingly. See id. ¶ 74,479, at 63,601. The more important the item, or the greater the possibility of material misstatement, the stronger must be the grounds for the auditor's opinion. See id. ¶ 74,479, at 63,601-63,602. These are "standards to which all accountants must adhere, and within Potts'[s] ready understanding." Id. ¶ 74,479, at 63,606. Potts correctly points out neither GAAP nor GAAS require concurring partner review. The major accounting firms themselves require concurring reviews on "SEC engagements," however. Id. ¶ 74,479, at 63,597 n.1. Having taken on the concurring review task, Potts also shouldered the duty to perform that task professionally. Although a concurring reviewer is not expected to do the audit all over again, Potts's own expert witness agreed that a concurring partner must evaluate the financial statements and audit in light of GAAP and GAAS. To do so competently, the concurring partner must observe the commonsense principles

the SEC applied here. Accordingly, we reject the view put forward by the AICPA that a concurring partner is not an auditor and thus not subject to GAAS.

Further, as the SEC pointed out in its opinion, see id. ¶ 74,479, at 63,606, by 1988 the SEC had issued several opinions and orders specifically addressing concurring partner review (or its equivalent under different names). The opinions slow the SEC has consistently evaluated the professional conduct of concurring partners under GAAP and GAAS. See SEC v. Grant Thornton, Accounting and Auditing Enforcement Release No. 118, 36 S.E.C. Docket 1005, 1986 WL 73198, at *3 (Oct. 16, 1986) ("quality control" reviewer is responsible to detect "inconsistencies or errors that . . . might evidence violations of GAAP and GAA[S]"); Stephen O. Wade, 47 S.E.C. 1081, 1092 (1984) ("second partner reviewer" engaged in improper professional conduct by approving financial statements that wrongly deferred losses in violation of GAAP); Lester Witte & Co., 47 S.E.C. 409, 420 (1981) (concurring review "inadequate" because "[i]t failed to discover that the . . . audit engagement had not been conducted in accordance with generally accepted auditing standards"); see also Seidman & Seidman, 48 S.E.C. 310, 331 (1985) (concurring partner must assure that audit workpapers "contain [] sufficient information to support significant accounting, auditing and reporting decisions"). In sum, Potts had a reasonable opportunity to know what the SEC expected of him, so we reject Potts's due process argument.

We affirm the SEC's order.

A true copy.

Attest: /s/ Michael E. Gans

CLERK, U.S. COURT OF APPEALS, EIGHTH CIRCUIT.

UNITED STATES COURT OF APPEALS

FOR THE EIGHTH CIRCUIT

No. 97-3710

Robert D. Potts,	*	
	*	
Petitioner,	*	
	*	
Vs.	*	Order Denying Petition for
	*	Rehearing and Suggestion
Securities and Exchange	*	For Rehearing En banc
Commission,	*	
	*	
Respondent.		

The suggestion for rehearing en banc is denied. The petition for rehearing by the panel is also denied.

September 30, 1998

Order Entered at the Direction of the Court:

/s/ Michael E. Gans

Clerk, U.S. Court of Appeals, Eighth Circuit

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 39126 / September 24, 1997

ACCOUNTING AND AUDITING ENFORCEMENT
Rel. No. 964 / September 24, 1997

Admin. Proc. File No. 3-7998

In the Matter of

ROBERT D. POTTS, CPA
c/o Briggs and Morgan
2400 IDS Center
Minneapolis, MN 55402

OPINION OF THE COMMISSION

RULE 2(e) PROCEEDING

Ground for Remedial Action

Improper Professional Conduct

Certified public accountant acting as concurring partner engaged improper professional conduct in concurring in issuance of audit reports containing unqualified audit opinions on the financial statements of a public company that improperly deferred cognition of operating losses and thus

materially misstated come. Held, it is in the public interest to suspend the accountant from practice before the Commission for nine months.

APPEARANCES:

J. Patrick McDavitt and Robert E. Woods, of Briggs and Morgan, for Robert D. Potts.

Carl A. Tibbetts and Sara A. Smith, of the Division of Enforcement, for the Office of the Chief Accountant.

Appeal filed:	June 6, 1994
Last brief received:	May 1, 1996
Oral Argument:	May 23, 1996

I.

Robert D. Potts, a certified public accountant and former partner with the accounting firm of Touche Ross & Co. and its successor Deloitte & (each referred to as "Touche"), appeals from the decision of an administrative law judge. Potts was the concurring partner for Touche's audits of Kahler Corporation ("Kahler"), a public company, for the fiscal 1988 and 1989. An "engagement partner" had primary responsibility for assuring the accuracy of these audits. Potts, as the "concurring partner," provided a second level of review, affording "additional assurance" that "(1) the financial statements [on this] SEC engagement[] . . . [we]re in conformity with generally accepted accounting principles . . . and (2) the firm's report thereon [wa]s in accordance with generally auditing standards."[1]

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[1] American Institute of Certified Public Accountants ("AICPA") Division of CPA Firms SEC Practice Section, SECPS Manual, Appendix E, at 1 (1986) ("SECPS Manual"). The SEC Practice Section is an

The law judge found that Potts engaged in improper professional in connection with the audits at issue and, accordingly, suspended him from practice before the Commission for eighteen months pursuant to Rule 2(e)(1) of our Rules of Practice.[2] Our findings are based on independent review of the record, except with respect to those findings not challenged on appeal.

The law judge's decision mistakenly notes that Potts' role was to "insure" that the financial statements and audits satisfied the standards of the profession. Concurring partners, like other accountants, provide only reasonable "assurance" in this regard, not a "guarantee."

II.

The concurring partner affords this Commission and public investors an independent "check" on the appropriateness of significant accounting, auditing, and reporting decisions. The question before us is whether Potts, as concurring partner, engaged in improper professional conduct when he concurred in his firm's issuance of unqualified audit opinions on Kahler's 1988 and 1989

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organization formed by the AICPA in the late 1970s, in the wake of Commission- instituted enforcement actions finding deficiencies in audits by major accounting firms, to establish guidelines and enhance the quality of audits of public companies. One of the guidelines established by the SEC Practice Section is that, for all "SEC engagements," as that term is defined in Appendix D to the SECPS Manual, a concurring partner must review the audit report and the financial statements before the audit report issues.

[2] On July 24, 1995, revised Rules of Practice governing Commission administrative proceedings became effective. Because these proceedings were docketed prior to that date, they have been conducted under the former Rules of Practice. See 60 Fed. Reg. 32,738 (1995). Former Rule 2(e)(1) (the basis of this proceeding) is now 17 C.F.R. 201.102(e)(1). We made no substantive changes to this rule.

financial statements. In those statements, Kahler, among other things, accounted for the operating losses of the University Park Hotel ("UPH" or "Hotel") as if they were the results of operations of a significant portion of a business held for disposal.

Potts became a Touche partner in 1975 and was Managing Partner for Touche's Twin Cities Office from the fall of 1988 to May 1993.[3] In 1986, Potts served Kahler as "General Services Partner," which, according to Potts, meant that Potts was the Touche partner "responsible for delivery of all services to the organization."[4] From 1987-1993, Potts was the concurring partner of Kahler's fiscal year audits.[5] During the relevant period, Potts had been practicing before the Commission for at least ten years and had served as concurring partner on approximately a dozen audits in addition to the two on which we focus here.

During the period covered by the financial statements at issue, Kahler was a Delaware company with its headquarters in Rochester, Minnesota, that primarily owned and managed hotels. Kahler's securities were registered under Section 12(b) of the Securities Exchange Act of 1934 ("Exchange Act"). Accordingly, Kahler was required by Section 13(a) of the

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[3] Potts left Touche on August 30, 1993. He subsequently worked as a consultant to the chief executive officer of a public company that was a Touche audit client. Counsel advised at oral argument that Potts currently is President and Chief Operating Officer of a major financial services company in Minnesota.

[4] Correspondence between Touche and Kahler in July 1986 specified that, as General Services Partner, Potts was responsible for "on-going business consultation."

[5] In its 1989 engagement letter to Kahler, Touche defined Potts' role as concurring partner broadly, stating that Potts would be "another partner, known to the [Audit Committee] and your management associates, who is familiar with your operations and [who] can substitute for [the engagement partner] in his absence. . . ."

Exchange Act to file with this Commission annual reports containing financial statements that had been certified by independent public accountants (here, Touche), and quarterly reports. Harold W. Milner served as Kahler's Chief Executive Officer through December 1989, when Kahler's Board of Directors replaced him. Gregory J. Melsen served as the Touche engagement partner on the Kahler audits at issue.

Kahler acquired the UPH in April 1987. In April 1988 the Kahler Board of Directors authorized management to explore the possibility of selling an interest in the UPH. In December 1988 Kahler engaged an investment banking firm, Piper, Jaffray, and Hopwood ("Piper"), to sell a 50 percent interest in an investment partnership, the assets of which consisted of the UPH and another hotel. During the two audit years, Kahler also formulated a number of investment proposals involving the UPH, offering to sell an interest in the Hotel.

During all of fiscal 1988 and through the close of business on the last day of Kahler's 1989 fiscal year (December 31, 1989), Kahler carried the UPH on the company financial statements as an "asset held for sale." This accounting implicitly represented that Kahler intended to dispose of the Hotel and also that, under relevant accounting principles, the Hotel's value (after giving consideration to costs and expenses directly associated with the Hotel's disposal and certain estimated income or losses from operations) was sufficient to permit any actual losses generated by the asset to be excluded from Kahler's statement of operations. As a result, the losses were capitalized (that is, added to the Hotel's carrying value on Kahler's books, and not reflected in the company's income statement). In fiscal year 1988, Kahler carried the Hotel at a reflected value of $16.532 million and capitalized operating losses of $1,347 million associated with the property. Kahler also chose to capitalize the $966,000 in losses associated with the Hotel for the entire

1989 fiscal year. As of the close of business on the last day of Kahler's 1989 fiscal year, Kahler "redesignated" in the UPH from an asset held for sale to Kahler property held as an operating asset. Kahler began depreciating and amortizing the UPH in 1990.

Kahler's accounting for the UPH had a material effect on Kahler's financial statements: Kahler posted net income of $239,000 in fiscal year 1988 rather than the net loss of $1.108 million that otherwise would have reported had Kahler recognized the UPH's operating losses, and similarly posted a net loss of $1.842 million in 1989, rather than a $2.808 net loss.[6]

Potts signed a memorandum concerning both the 1988 and 1989 audits stating that he had completed his review, the purpose of which was, as stated in the memorandum, to "provide additional assurance that the financial statements are in conformity with [Generally Accepted Accounting Principles] and that [his] Firm's report thereon is in accordance with [Generally Accepted Auditing Standards]." Based on his review, Potts concurred in the decision each year to release Touche's unqualified audit opinion.[7]

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[6] The amounts of the Kahler-deferred losses in 1988 were disclosed in the footnotes to the financial statements for fiscal 1988. The amounts of depreciation and amortization (but not the operating losses) not recognized in fiscal 1989 were disclosed in the footnotes to the financial statements for that year.

[7] Kahler, its Chief Executive Officer Milner, Kahler Treasurer and Chief Financial Officer Steven R. Stenhaug, and Touche engagement partner Melsen each settled Commission charges relating to their respective roles in what this Commission previously found, in connection with those settlements, to be Kahler's improper accounting treatment and financial statement presentation of the UPH during the audit years at issue. In the Matter of Kahler Corporation, Harold W. Milner and Steven R. Stenhaug, Exchange Act Rel. No. 32916, Acctg. And Audit. Enf. Rel. No. 481 (Sept. 17, 1993), 55 SEC Docket 24; In the Matter of Gregory J.

III.

Potts claims that the accounting treatment at issue was "appropriate and proper in all respects." This claim is belied by the record. Guided by several key accounting pronouncements recognized as Generally Accepted Accounting Principles ("GAAP"), including the Opinion of the Accounting Principles Board ("APB") No. 30, "Reporting the Results of Operations -- Reporting the Effects of Disposal of a Segment of Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions" ("APB 30") on which Potts claims to have relied in reviewing the accounting, we conclude that Kahler improperly accounted for the UPH.

APB 30 applies to the sale of "segments," defined as the entirety of a line of business. APB 30 permits a company that plans to dispose of a business segment to defer current operating losses generated by the segment, provided the company satisfies a series of requirements. These requirements include that management determine that the company will recognize a net gain upon sale of the business segment; commit to a "formal plan" to dispose of the business segment; and disclose separately in the notes to the company's financial statements the business segment's results of operations and other specified information.[8] APB 30 has been interpreted authoritatively by the American Institute of Certified Public Accountants ("AICPA") to require that the gain or loss on a sale of a significant portion of a line of business-- in contrast to a "business segment" -- should be calculated consistent APB 30 as if it were a "segment" and to

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Melsen, CPA, Exchange Act Rel No. 32917, Acctg. And Audit. Enf. Rel. No. 482 (Sept. 17, 1993), 55 SEC Docket 38.

[8] APB 30, 8, 14, 15, 18.

require, with respect to that portion, the specified footnote disclosures set forth in APB 30.[9]

A subsequently-issued consensus position of the Emerging Issues Task Force ("EITF") of the Financial Accounting Standards Board ("FASB") [10] -- "Discontinued Operations with Expected Gain and Interim Operating Losses," EITF Issue No. 85-36 ("EITF 85-36") -- also is relevant here. EITF 85-36 emphasizes that, consistent with the AICPA's interpretation of APB 30, all the conditions of APB 30 applying to the disposal of a segment of a business apply to the disposal of a significant portion of a line of business accounted for pursuant to APB 30.[11] EITF 85-36 does not define the term "significant portion of a line of business." Kahler's accounting for the UPH was based on the assumption -- which we also make here, without resolving the question -- that the UPH, a single hotel, qualified as a significant portion of a line of business.

A. To capitalize operating losses under APB 30 and EITF 85-36, an issuer must expect to be able to account for the disposal as a sale pursuant to GAAP. An issuer's ability to recognize a real estate transaction as a sale in its financial statements is determined based upon criteria set forth in FASB's Statement of Financial Accounting Standards

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[9] See AICPA Accounting Interpretation AIN-APB30, #1, "Reporting the Results of Operations: Accounting Interpretations of APB Opinion No. 30" (Nov. 1973).

[10] The EITF's consensus positions on accounting issues are GAAP.

[11] Kahler referred to the UPH in its financial statements as an "asset held for sale." More precisely, consistent with the relevant accounting pronouncements, Kahler treated the Hotel as a "segment of a business held for disposal." For consistency and simplicity, in this opinion we refer to the UPH as an "asset held for sale" or an "asset," and refer to the relevant accounting treatment of such an asset as "APB 30 treatment."

("FAS") 66, "Accounting for Sales of Real Estate."[12] Pursuant to FAS 66, a real estate transaction will be accounted for as a financing, or profit-sharing arrangement rather than a sale if the seller retains certain of the risks of ownership. Here, over the two-year period beginning in April 1988, Kahler formulated at least twelve investment proposals regarding the UPH that sought investor participation in ownership -- not outright sale -- of the UPH.[13] Thus, APB 30 treatment of the Hotel's losses should not have been accorded here.

B. Moreover, Kahler did not have a "formal plan" of disposal for the Hotel, as that term is used in APB 30 and EITF 85-36.[14] In brief, the "formal plan" must at a minimum: (a) identify the asset to be disposed of, the expected method of disposal, and the anticipated period for final disposal, measured from the date that the formal plan was established (the "measurement date"); (b) initiate an active program to find a buyer; (c) provide an estimate of the results of operations of the segment from the measurement date to the

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[12] FASB Original Pronouncements, Statement of Financial Accounting Standards 66, "Accounting for Sales of Real Estate" (1982) ("FAS 66"). Under FAS 66, a profit or gain may be recognized in full when real estate is sold if, among other things, the seller has transferred to the buyer the usual risks and rewards of ownership and the seller does not have a substantial continuing involvement with the property. FAS 66, 18, 25-31.

See, e.g., Stephen P. Clark, CPA, Acctg. and Audit Enf. Rel. No. 239 (Aug. 11, 1989), [198- AAER Transfer Binder] Fed. Sec. L. Rep. (CCH) 73,708, at 63,2747-48 (fundamental concept of revenue recognition incorporated in GAAP is that "the seller must transfer the usual risks and rewards of ownership, and must not be obliged to perform significant activities after the sale to earn the profit").

[13] For instance, Kahler in certain proposals guaranteed a stated return on the investment, and retained an equity interest in the Hotel.

[14] APB 30, 14.

disposal date; and (d) estimate the proceeds to be realized from the disposal. Not only can there be no viable "formal plan" under APB 30 and EITF 85-36 if there is no intention to transfer the segment outright, nothing in the record demonstrates that the elements set forth above were satisfied.[15]

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[15] Potts claims that a formal plan was discernible, in its "various components," from the contents of the 1988 and 1989 Top Files. (Touche referred to the folder of its auditors' significant work papers as the Top File.) We do not agree. We find significant APB 30's requirement that a plan be "formal." This is not to say that a formal plan may not be set forth in a form such as minutes of a meeting of a corporate body empowered to make the decisions called for under APB 30. Nevertheless, mere references in meeting minutes to what may be certain elements required for a formal plan are not sufficient (see, e.g., the February 1989 Board of Directors meeting minutes reflecting that the Audit Committee was "satisfied" with Touche's accounting for the UPH in a pending sale mode and that "the numbers and assumptions associated with the valuation [were] reasonable").

We also reject Potts' alternative assertion that an oral report to Potts by Melsen, the engagement partner here, amounted to the requisite formal plan. Donald J. Moulin, an expert witness offered by our Office of the Chief Accountant ("OCA"), who had served as a concurring partner on 10 to 20 audits involving APB 30 issues, testified that, in industry usage, "formal plan" indicates a written plan. Both Moulin and Barry Jay Epstein, another OCA expert witness, testified persuasively that Melsen's oral "assurances" to Potts could not in themselves constitute a formal plan. An auditor may describe, in a conversation with his or her partner, the elements of management's formal plan, but that description cannot itself constitute the formal plan.

Moreover, we do not agree that documents created by an auditor themselves may constitute a formal plan, although they may memorialize in one location the components of management's formal plan. We thus reject Potts' attempt to fashion a "formal plan" out of a Kahler audit memorandum prepared by Touche, which states that it was Kahler's "intent" to sell the UPH and that "[t]he net realizable value of the property was assessed in the underlying workpapers and the carrying value at cost was deemed appropriate."

C. In accordance with the threshold requirements for deferral of operating losses set forth in APB 30 and EITF 85-36, a company must estimate the net realizable value ("NRV") of the asset slated for sale -- that is, the gain or loss to be realized on sale.[16] The company must satisfy itself that the NRV will result in a gain (after giving consideration to costs and expenses directly associated with the asset's disposal and certain estimated income or losses from operations) or losses may not be deferred. We have concluded, on our review of this record, that, at the time Kahler decided to account for the Hotel as an asset held for sale, Kahler management failed to assess adequately the Hotel's net realizable value and failed to estimate the Hotel's operating losses to be incurred prior to sale. Without adequate estimates, Kahler's management had no valid basis to conclude that the Hotel's operating losses could be deferred.

D. Kahler's decision to treat the UPH as an asset held for sale from the beginning of fiscal 1988 also was problematic. Even assuming that APB 30 treatment properly could be accorded here (and we do not believe that it could be), Kahler's Board did not authorize disposal of (even an interest in) the Hotel until mid-April 1988. This, therefore, was the earliest colorable "measurement date," or date from which operating losses could be deferred under APB 30.

We accordingly conclude on this record that Kahler's financial statements filed with its Forms 10-K and 10-Q during fiscal years 1988 and were not presented by Kahler in accordance with GAAP because the company improperly deferred operating losses related to the operation of the UPH.[17]

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[16] APB 30, ¶ 15.

[17] We also note that, although Kahler's quarterly reports for the first three quarters of 1988 filed with this Commission disclosed that the asset held for sale was the UPH, Kahler's 1988 and 1989 financial statements

IV.

The Order Instituting Proceedings charged, and the law judge found, that Potts engaged in improper professional conduct in violation of Rule 2(e)(1) of our Rules of Practice. Central to this case were the professional standards governing Potts' conduct. As a certified public accountant, Potts was expected to understand GAAP and Generally Accepted Auditing Standards ("GAAS") and to recognize when departures were made from them. In addition, as a public accountant, Potts was required to determine that financial statements filed with this Commission conformed to the criteria for the form and content of financial statements set forth in our Regulation S-X.[18] Potts' status as a concurring partner rather than an engagement partner did not insulate him from these duties to adhere to GAAS and our Regulation S-X, and to recognize departures from GAAP.

Potts, as a member of the AICPA and a partner at Touche, itself a member of the AICPA's SEC Practice Section ("SECPS"), also was expected to comply with the AICPA's Auditing Standards and Ethics Rules and to meet the requirements of the SECPS. The SECPS Manual provides criteria and guidelines for member firms' concurring partner review policies,[19] including the following "minimum" policies and procedures for concurring partner review:

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departments from APB 30 and EITF 85-36 in not identifying, as required, the particular asset being held for sale, the expected disposal date, or the loss from the beginning of the disposal period. See APB 30, ¶ 18.

[18] 17 C.F.R. 210.1-01 et seq.

[19] Potts argues that these guidelines do not apply specifically to his conduct, since only firms can be members of the SECPS. Potts, however, as a concurring partner performing audit functions on behalf of his SECPS member firm, is governed by the SECPS guidelines. It appears that the SECPS has at least in one instance expelled an individual accountant from

> [R]eading the financial statements and the firm's report thereon and making an objective review of significant accounting, auditing, or reporting considerations. This review should be performed prior to the release of the report and should include discussions with the partner in charge of the engagement and review of selected working papers.[20]

Consistent with these requirements, Potts was bound to exercise due professional care in the performance of his professional services.

> [21]GAAS makes clear that all auditors -- not just those serving on the engagement team -- must perform their work due care. "Due care imposes a responsibility upon each person within independent auditor's organization to observe the standards of field reporting."[22]

As relevant here, in determining whether the audits were conducted in accordance with GAAS, Potts was required to consider:

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the Practice Section for, among other misconduct, failing to obtain concurring partner reviews on audits. See Thomas Page Taylor, Exchange Act Rel. No. 31244 (Sept. 28. 1992), 52 SEC Docket 2409, 2411.

[20] SECPS Manual at 1.

[21] AICPA, Codification of Statements on Auditing Standards, AU § 150.02 (1995) (hereinafter "AICPA AU § __"). Rule 202 of the AICPA's Code of Professional Conduct recognizes Statements on Auditing Standards as interpretations of GAAS.

[22] AICPA AU § 230.02.

(1) the Third Standard of Field Work, directing that "[s]ufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit";[23] and

(2) the First Standard of Reporting, specifying that the auditor's "report shall state whether the financial statements are presented in accordance with generally accepted accounting principles." [24]

Also applicable were GAAS standards establishing requirements for the auditor whose examination causes him to believe that material errors or irregularities may cause the financial statements to contain a material misstatement. These standards require the auditor to consider their implication and, among other things, to extend his auditing procedures, if practicable, "to obtain sufficient evidential matter to determine whether in fact material errors or irregularities exist and, if so, their effect."[25] Additionally, Potts, in the exercise

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[23] AICPA AU § 150.02, Standards of Field Work, ¶ 3. See also AICPA, 2 Professional Standards (CCH), ET § 201, at 4561 (1996); AICPA AU §§ 326 and 339.

[24] AICPA AU § 150.02, Standards of Reporting, 1. Professional standards further precluded Potts from permitting issuance of an unqualified opinion stating affirmatively that Kahler's financial statements were presented in conformity with GAAP, if those financial statements contained any departure from a promulgated accounting principle that had a material effect on the financial statements taken as a whole. AICPA, 2 Professional Standards (CCH), ET § 203, at 4581 (1996); AICPA AU § 508.14-15.

[25] Statement of Auditing Standards ("SAS") No. 16.14 (superseded by SAS No. 53 (codified at AICPA AU § 316.08), effective for audits of financial statements for periods beginning on or after January 1, 1989). SAS No. 16.14 specifies that an auditor must exercise "the proper degree of professional skepticism to achieve reasonable assurance that material

of his audit responsibilities, was required to consider the related GAAS directive that "[t]here should be stronger grounds to sustain the independent auditor's opinion with respect to those items which are relatively more important and with respect to those in which the possibilities of material misstatement are greater than with respect to those of lesser importance or those in which the possibility of material misstatement is remote." [26]

The foregoing are the professional standards that are relevant in determining whether Potts engaged in improper professional conduct.[27]

V.

Mindful of the AICPA's cautionary language that "the subsequent discovery that a material misstatement exists in the financial statements does not, in and of itself, evidence inadequate . . . judgment on the part of the auditor,"[28] we now turn to an analysis of Potts' conduct. That analysis is shaped, in part, by our recognition of the following: Potts' extensive professional experience and familiarity with Kahler's operations; Potts' knowledge of the contents of the work

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errors or irregularities will be detected"). SAS No. 53 further specifies that "[s]ince the auditor's opinion on the financial statements is based on the concept of reasonable assurance, the auditor is not an insurer and his report does not constitute a guarantee "

[26] AICPA AU § 150.04.

[27] In his dissent, Commissioner Wallman states that it is not clear from the record in this matter what was expected of a concurring partner at the time of the Kahler audits. The relevant professional standards we apply here are all taken directly from accounting literature. These standards were just as applicable when Potts performed his Kahler audit work as they are today.

[28] AICPA AU § 316.08.

papers (given Potts' counsel's statement at oral argument before us that Potts had reviewed the entire Top File for each audit at issue); and Potts' knowledge that the accounting treatment utilized was material to the financial statements.

> The record includes the testimony of three experts in the fields of accounting and auditing who testified in detail and at length, in support of the Division's case, on the role of a concurring partner during the relevant period. Potts offered his own expert's testimony as well, and that expert, Edward J. Kerans (a certified public accountant and a Coopers & Lybrand partner) articulated his own understanding of the concurring partner's role during the applicable period. Each of these witnesses premised his analysis of Potts' conduct on the applicability of GAAS, with the attendant requirement of due professional care, that we discuss and apply here. The record testimony leaves no doubt that the experts offered their opinions based upon the standard applicable to concurring partners when Potts performed his Kahler audit work (which, in any event, as we already have noted, is the same standard in effect currently, and was the standard in effect when the experts testified). We accordingly reject any suggestion that the experts were assessing Potts' role in the audits against a standard not known to him during the time of the audits.

A. In March 1988, Potts and Melsen met personally with Kahler's Treasurer and Chief Executive Officer, Milner, and Kahler's Chief Financial Officer, Stenhaug, over lunch, and discussed, apparently briefly, the parameters of

accounting for the UPH as an asset held for sale.[29] Thereafter, Melsen informed Potts that Kahler had adopted a plan to sell its equity interest in the Hotel. These assurances, however, were contradicted by documentary evidence in the 1988 Top File: the April 1988 meeting minutes of Kahler's Board of Directors, which plainly indicate that management had authorized only "the sale of an interest" in the Hotel, and the September 1988 Board meeting minutes, which reflect Board discussion of "[t]he subject of continuing to find a purchaser to share in the ownership of [the Hotel]."

Melsen subsequently advised Potts, as the 1988 audit proceeded, that Melsen had uncovered evidence -- a contract letter between Piper and Kahler that engaged Piper to sell a partial interest in the Hotel (which he showed to Potts) -- that caused Melsen to question Kahler's commitment to dispose of its interest outright. In an effort to clarify this inconsistency, Potts and Melsen again met with Milner. After Milner assured the auditors that the company intended to sell the Hotel, and sought to explain away the contract letter as a means of generating interest in an outright purchase of the UPH, Potts suggested that Melsen meet with Kahler's audit committee regarding whether the company in fact was committed to disposal. Potts accepted Melsen's subsequent oral report -- unsupported by documentary evidence undercutting the Board minutes and the Piper letter -- that Kahler was committed to a plan to dispose of its entire interest in the UPH. We conclude that doing so was improper.

As an initial matter, we agree with Potts that he, as concurring partner on the audits, did not act unreasonably

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[29] The law judge found grave inconsistencies between Potts' investigative and hearing testimony regarding the extent and duration of this discussion about the UPH. We have conducted a de novo review of this matter and do not find the testimony so markedly inconsistent. Accordingly, we disagree with the law judge's finding that Potts' hearing testimony on this point was not credible.

when he was satisfied initially with his partner Melsen's indications that Kahler intended to dispose of its entire interest in the Hotel. We also agree that Potts, upon becoming aware of audit documentation and his partner's concerns that Kahler planned to sell only a partial interest, acted reasonably in meeting first with Milner and then in directing Melsen to inquire further about Kahler's intentions regarding the Hotel. We conclude, however, that Potts thereafter did not fulfill his responsibilities.

Melsen's assessment that management in fact was committed to disposal was based solely on management's oral assurances that did not reasonably explain the contradictory documentary evidence.[30] We conclude that Potts was obligated to inquire further concerning management's commitment to disposal, as "[t]here should be stronger grounds to sustain the independent auditor's opinion with respect to those items which are relatively more important and with respect to those in which the possibilities of material misstatement are greater than with respect to those of lesser importance or those in which the possibility of material misstatement is remote."[31] Potts, for example, readily could have probed Melsen, through obvious follow-up questions, to test the reasonableness of Melsen's conclusions, including whether Melsen had requested and reviewed documentation that Kahler in fact had authorized Piper (or any other entity) to dispose of Kahler's entire interest in the Hotel. Alternatively, Potts could have suggested that Melsen direct

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[30] We do not agree that the audit committee meeting minutes prepared in February 1989 that are in the 1988 Top File, which reflect that the committee was "satisfied" with the accounting as Melsen explained it, constitute "[s]ufficient competent evidential matter" (AICPA AU § 150.02, Standards of Field Work, 3) that Kahler intended to dispose fully of the UPH, or constituted a formal plan.

[31] AICPA AU § 150.04.

Kahler to have Piper representatives speak with Melsen personally about the matter. This approach would have been consistent with the general auditing presumption that "[w]hen evidential matter can be obtained from independent sources outside an entity, it provides greater assurance of reliability for the purposes of an independent audit than that secured solely within the entity." [32]

Alternatively, Potts could have asked to be shown supporting documentary evidence of management's intent to dispose of the Hotel. This latter request would have yielded results. Potts has conceded that review of the investment proposals, for example, would have cast doubt on the UPH accounting, and, as we have stated, no formal plan for disposal in fact existed. Particularly because the audit documentation to which Potts had been directed contradicted reliance on APB 30, it is our view that Potts acted improperly in failing to pursue -- through one of the alternative means we have laid out above, or another reasonable method -- whether management in fact had documented its commitment to disposal.

With respect to Potts' conduct in connection with the fiscal 1989 audit, Potts cites as audit evidence of intent to dispose of the property outright a September 1989 proposal to purchase the UPH that was included in the 1989 Top File. However, also included in that Top File was another investment proposal reflecting Kahler's intention to subsidize the purchasers of the UPH directly to the extent necessary to provide a specified annual return on their investment. Faced once again with contradictory evidence as to the availability of APB 30 treatment, Potts again "went along" with Kahler's decision to defer UPH losses in fiscal 1989. We conclude that Potts acted improperly in both audit years.

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[32] AICPA AU § 326.19.

B. Auditors must satisfy themselves that a company deferring and capitalizing losses from continuing operations in accordance with APB 30 has determined the NRV of the asset held for disposal.[33] As the law judge observed, the only NRV-related evidence in the 1988 work papers is a one-page document prepared by a Touche senior manager for the audit. No independent appraisal of the UPH was performed and thus none is included in these work papers. The Touche document, moreover, used two different (but each highly-favorable-to-Kahler) approaches to derive NRV, neither of them valid, as Potts later acknowledged in his hearing testimony.[34]

Potts, in connection with the 1988 audit, failed to ascertain that sufficient competent audit evidence relating to valuation of the UPH supported Kahler's deferral of significant UPH operating losses. This failure amounted to improper professional conduct.[35] In reaching this conclusion, we consider the fact that, as Potts observes in his petition for

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[33] As Potts' witness Thomas Bintinger, a Touche partner and, during the relevant period, national director of accounting and auditing professional standards in the firm's National Office, testified, Kahler's management was responsible for supplying the auditors with NRV estimates that Touche then would review.

[34] Because the document was offered and received into evidence after the close of the hearing, we have determined not to consider Investigative Exhibit 47 (which the Division of Enforcement ("Division") asserts is the original of the investigative exhibit shown to Potts during his investigative deposition).

[35] As we stated supra note 30, we do not consider the Kahler Board of Directors' February 1989 meeting minutes -- stating that the Audit Committee considered "reasonable" the numbers and assumptions associated with the valuation -- to be sufficient competent evidential matter of the required formal plan. Nor do we agree with Potts that he could be satisfied solely with Melsen's communication to him that the Audit Committee was "comfortable" that Kahler would recognize a gain on sale.

review, Touche, in connection with the 1988 audit, had determined that the engagement presented "moderate" risk of misstatement. We consider that this risk should have caused Potts, at a minimum, to ask questions and to exercise a heightened degree of professional skepticism on the valuation issue.

During the 1989 audit, Melsen asked Kenneth P. Riggs in Touche's Valuation Office for "assistance in determining the fairness of the carrying value" of the UPH. Riggs used a discounted cash flow analysis to derive a market value of $11.4 million. This value was well below the $16.754 million book value for the Hotel. Accordingly, contrary to Potts' claim to us, Kahler could have had no reasonable expectation of gain on sale of the Hotel (assuming it intended to dispose of its entire interest in the UPH, which the record establishes it did not), as required for deferral of losses under APB 30 and EITF 85-36. [36]

On receipt of the Riggs analysis, members of the audit team substituted Kahler's budgeted projections of future cash flows for the projections, based on historical results, used by Riggs, and lowered the discount rate Riggs had utilized. The audit work papers do not explain adequately these alterations or document the basis for these decidedly more favorable assumptions. It appears that the numbers in the work papers were changed in an effort to demonstrate compliance with the requirements of APB 30 and EITF 85-36. We conclude that Potts, who examined both the Riggs analysis and the changes made to it before the 1989 audit report issued, simply to

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[36] We cannot agree with Potts' assertion before the law judge that he acted reasonably in assuming that, because in late 1989 Kahler received an offer to purchase the UPH for $16.5 million, Kahler reasonably expected a gain on disposal. As the Board meeting minutes Potts reviewed on this matter reflected, Kahler's officers and directors dismissed the offer as not "economically justif[iable]," because it was conditioned on Kahler paying a high level of annual rent to the purchaser.

correct "errors" in the Riggs analysis, rather than regarding these alterations with due professional skepticism. The use of Kahler's projections in particular was problematic, as the 1989 Top File includes various documentation that, when considered together, strongly cautioned against reliance on Kahler-generated projections. [37] In light of the foregoing, we conclude that the evidence available to Potts before the 1989 audit report issued demonstrated that there could be no reasonable expectation of gain on sale of the UPH. [38]

C. With respect to Kahler's decision to treat the UPH as an asset held for sale from the beginning of fiscal 1988, Potts

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[37] For example, a Kahler Board member's expressions of concern over Kahler's "history" of "aggressive projections," are reflected, as is Melsen's comment, in a February 1990 memorandum, that Milner, Kahler's CEO, took an "aggressive posture regarding accounting." The 1989 Top File also includes notes of a conversation between Melsen and Kahler's audit committee chairperson, reflecting that Kahler's Board, after replacing Milner as CEO in late 1989, concurred in the Audit Committee's direction to management "to develop more conservatism in the Company's financial statements." That Top File also includes a December 1989 memorandum reflecting that Touche assessed the "[m]ain sources of audit risk . . . [as] the client's aggressive attitude toward accounting.

[38] Potts contends that, because Kahler reclassified the UPH as an operating asset as of the close of business on December 31, 1989, the applicable accounting authority shifted from APB 30's and EITF 85-36's NRV analysis to an "impairment of value" analysis under another EITF Issue. See 1 EITF Abstracts, EITF Issue No. 84-28, "Impairment of Long-Lived Assets," at 59-60. Accordingly, in Potts' view, the alterations in the Riggs discounted cash flow valuation are not probative of any improper professional conduct (since the Riggs analysis was irrelevant at the time it was created and altered). To the contrary, consistent with the basic premise of APB 30 and EITF 85-36, a company must have a reasonable expectation of gain on disposition during the entire time an asset is held for sale in order to defer operating losses, and APB 30's requirements must be met during the entire period of deferral. By deferring the losses on the UPH, Kahler utilized APB 30 accounting for the entirety of 1989. The Riggs valuation was highly relevant to whether that accounting was permissible.

testified that he and Melsen, after discussion, agreed that the appropriate measurement date was "towards the end of the first quarter." Accordingly, Potts' concurrence in Kahler's reliance on APB 30 and EITF 85-36 for the entirety of fiscal 1988 is inexplicable. We agree with the law judge that, in this connection, too, Potts engaged in improper professional conduct.

D. With respect to Potts' liability in connection with the 1989 financial statements, we reject his claim that Touche's National Office's concurrence in treating the Hotel as an operating asset as of the close of business on the last day of 1989, and in approving proposed footnote disclosure of the change in status from the end of 1988, insulates his conduct. Our focus, unlike that of the National Office, is not on the end-of-year financial statement presentation of the UPH. Rather, it is on Potts' concurrence in Kahler's reliance on APB 30 and EITF 85-36 for any portion of fiscal year 1989, given the "red flags" raised about the propriety of this accounting treatment. [39]

VI.

In sum, Kahler's financial statements for fiscal years 1988 and 1989 departed from GAAP in a number of significant respects, and the Touche audits of those financial statements were not conducted in accordance with GAAS. Based on our de novo review, we agree with the law judge that Potts acted

[39] We have not undertaken to analyze whether the accounting treatment accorded the UPH in the 1989 financial statements would have been consistent with GAAP, had Kahler in fact intended during a portion of fiscal year 1989 to dispose of the Hotel (and met the other requirements for deferral of losses set out in APB 30 and EITF 85-36), and we thus take no position on that issue.

recklessly[40] in indicating, with respect to both audits, that he had reviewed the financial statements and concluded that they satisfied the standards of the profession.[41] We conclude that, in light of the "total audit environment," [42] which reflected the keen significance to the financial statements of UPH loss deferrals and the heightened risk of material misstatement present in both audit years, Potts' deviations from the duties imposed by GAAP and GAAS constitute improper professional conduct.[43] A concurring partner provides important additional assurance that the audit has been conducted consistent with GAAS and that the financial statements meet the requirements of GAAP; his or her role is

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[40] As noted in our opinion in Checkosky & Aldrich, Exchange Act Rel. No. 38183 (January 21, 1997) 63 SEC Docket 1948, 1957, n.23, citing SEC v. Steadman, 976 F.2d 636, 641-42 (D.C. Cir. 1992), recklessness has been described as "not merely a form of ordinary negligence; it is an 'extreme departure from the standards of ordinary care, which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.'"

[41] We reject Potts' claim that there is no factual basis for the law judge's decision against Potts. As the Division points out, the staff introduced over 200 exhibits, and the law judge received expert testimony from a number of witnesses. Expert testimony can constitute direct evidence.

[42] Ernst & Ernst, 46 S.E.C. 1234, 1262 (1978); compare Touche Ross & Company, 45 S.E.C. 469, 473 (1974) (settlement) (circumstances should have required [auditor] to extend substantially its auditing procedures and to regard management representations with extreme care").

[43] Potts, in his role as concurring partner on these audits, was obligated to make an objective review of significant accounting, auditing, or reporting considerations. (See text accompanying notes 1, 19, & 20, supra.) As we have discussed in detail (see Part V of this opinion, supra), this record is replete with instances of Potts' demonstrated disregard for his obligation to exercise due care with respect to, and to bring professional skepticism to bear upon, the information he obtained in connection with the two audits.

to provide substantially more than "window dressing." Potts' substantial departures from his professional duties establishes that this Commission cannot rely upon Potts to perform diligently and with reasonable competence his audit responsibilities.[44]

> We reject Potts' claim that, because the Order Instituting Proceedings in this matter did not specify that Potts acted recklessly, Potts cannot be found to have acted recklessly. The Order charged that Potts "engaged in improper professional conduct" by violating GAAS and by not following GAAP. Commission counsel put on evidence of Potts' recklessness beginning with the testimony of its first witness, and Potts' counsel specifically addressed Potts' state of mind at the hearing and in briefing.

VII.

On several fronts, Potts challenges our authority to institute this action. First, Potts challenges our general authority to discipline accountants. Our Rule 2(e), however, is a valid exercise of the Commission's rulemaking authority under Section 23(a)(1) of the Exchange Act. The appellate courts that have addressed the validity of our Rule 2(e)

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[44] Because we conclude that Potts acted recklessly, it is not necessary that we reach here the issue Commissioner Wallman explores in dissent -- "whether mere negligence, or even no culpable state of mind, is sufficient for an action under the Rule." Compare Checkosky, 63 SEC Docket 1948 (addressing, on remand from court of appeals, whether Rule 102(e)(1)(ii) requires a particular mental state). We do agree that, in certain instances, an appropriate response to a professional's actions may be this Commission's referral of that professional to a professional association.

authority have held that the Rule "is 'reasonably related' to the purposes of the securities laws."[45]

Second, Potts contends that we have acted unfairly by enforcing Rule 2(e) against him in this context. In his view, Rule 2(e) is unconstitutionally vague as applied to concurring partners because it fails to provide adequate notice of what conduct is prohibited.[46] While this matter represents the first litigated proceeding to come before us involving an accountant acting solely as a concurring partner, we cannot agree that Potts was without guidance as to appropriate professional standards.[47] In this matter -- basic precepts of

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[45] Davy v. SEC, 792 F.2d 1418, 1421 (9th Cir. 1986); Touche Ross & Co., supra, 609 F.2d at 582 (citation omitted). See also Checkosky and Aldrich v. SEC, 23 F.3d 452, 456 (D.C. Cir. 1994) (opinion of Silberman, J.) (noting that the D.C. Circuit, in Polydoroff v. ICC, 773 F.2d 372, 374 (D.C. Cir. 1985), affirmed the principle, articulated by the Second Circuit in Touche Ross & Co., that there can be little doubt that the Commission, like any other institution in which lawyers or other professionals participate, has authority to police the behavior of practitioners before it).

[46] Potts argues, among other things, that this Commission may act against a concurring partner only after it (1) promulgates a rule that sets forth the required scope of a concurring partner's review of an audit of a public company (or that specifies what constitutes "improper professional conduct" by an accountant acting solely in the capacity of a concurring partner) or (2) sets forth, in an adjudicatory opinion with solely prospective application, what amounts to such a rule.

[47] See, e.g., United States v. Hearst, 638 F.2d 1190, 1197 (9th Cir. 1980), cert. denied, 451 U.S. 938 (1981) (the phrase "conduct unbecoming a member of a bar" is not unconstitutionally vague because "[i]t refers to the legal profession's 'code of behavior' and 'lore,' of which all attorneys are charged with knowledge" and which are illustrated by the American Bar Association's Code of Professional Responsibility); Crimmins v. American Stock Exch., Inc., 368 F. Supp. 270, 277 (S.D.N.Y. 1973), aff'd, 503 F.2d 560 (2d Cir. 1974) (rejecting a vagueness challenge to American Stock Exchange, Inc. rule barring conduct in violation of "just and equitable principles of trade" because an experienced securities representative "may fairly be charged with knowledge of the ethical standards of his profession").

GAAS, such as the duties to exercise, to evaluate whether audit conclusions are supported by sufficient competent evidential matter, and to bring to the work an appropriate level of professional skepticism, and of GAAP -- are standards to which all accountants must adhere, and within Potts' ready understanding. Accordingly, we have the power to apply them in analyzing conduct in this proceeding. We need not act prospectively, given that, as just discussed, we have concluded that GAAP and GAAS apply and that Potts, during the two audit years at issue, recklessly failed to carry out his important professional responsibility to provide additional assurance regarding the financial statements under audit.[48]

[49]Additionally, in our opinions and orders in a range of settled matters, we have provided guidance to the accounting profession as to the standards expected of concurring partners that we enforce here. In Lester Witte & Co., Exchange Act Rel. No. 17423, Acctg. . No. 285 (Jan. 7, 1981), [1937-1982 ASR Transfer Binder] Fed. Sec. (CCH) 72,307, at 62,859, for example, we made it quite clear that the purpose of a concurring partner review was reasonably to assure that the quality of the work performed during the audit was consistent with the standards of the profession. [50] In SEC v. Grant

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[48] In William R. Carter, et al., 47 S.E.C. 471, 508 (1981), in contrast, we concluded that no "generally recognized norms of professional conduct" governed the conduct at issue.

[49] Various commentators have duly noted our recognition of the significance of concurring partner review. See, e.g., Robert K. Mautz and Louis W. Matusiak, Concurring Partner Review Revisited, Journal of Accountancy, March 1988, at 56, 60.

[50] Id. at 62,865. We found that the concurring partner whose conduct we reviewed relied unduly on the engagement partner's oral assurances, looked at only a few accounts receivable work papers (although he considered accounts receivable and inventory the most important asset accounts of the company), and failed to inquire into, among other things,

Thornton, Civ. Act No. 86-6832 (S.D. Fla.), Acctg. and Audit. Enf. Rel. No. 118 (Oct. 16, [1982-87 AAER Transfer Binder] Fed. Sec. L. Rep. (CCH) 73,518, we instituted and settled an action against, among others, an "impartial control review" auditor who, like Potts, had the responsibility to detect inconsistencies or errors that appeared in the workpapers that might evidence violations of GAAP and GAAS. We alleged that the auditor failed to detect numerous inconsistencies, errors, and violations of GAAP and GAAS disclosed by the workpapers and notes to the financial statements.[51] Further, the Stephen O. Wade matter, Exchange Act Rel. No. Acctg. and Audit. Enf. Rel. No. 32 (June 25, 1984) [1982-1987 AAER Binder], Fed. Sec. L. Rep. (CCH) 73,416, highlighted the improper conduct of a concurring partner who permitted a company improperly to defer losses on securities.[52]

We also previously have explored the nature of due care and professional skepticism, for example, as these concepts relate to accountants generally. We concluded, for instance, in one settled matter presenting circumstances with marked similarity to those at issue here, Nilssen, 48 S.E.C. 570 (1986), that the partner in charge of the audits at issue

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the lack of workpaper documentation. We did not sanction the concurring partner, as we concluded that the partner's laxity could be attributed in part to the firm's "inadequa[te]" concurring partner review program. Id.

In settling the proceeding, the firm agreed to submit to a review by the SECPS's Peer Review Committee of, among other things, its quality control policies and procedures on Commission audits.

[51] That auditor consented to the entry of an injunction permanently enjoining him from future violations of Section 17(a) of the Securities Act.

[52] We concluded that the concurring partner knew both that the relevant accounting pronouncements permitted loss deferral only where the securities were substantially the same, and that the securities at issue differed in the key respects of interest rate, estimated lives and yields. In settling the proceeding, the concurring partner agreed to a three-year suspension from auditing Commission-filed financial statements.

engaged in improper professional conduct because he had not followed up on his request to management for information on the disposition of a significant portion of a company's shares, made after his review of documentary evidence that contradicted outside counsel's "verbal assurances" that the shares were not regarded as outstanding.[53] Similarly in Hertz, Herson & Co. 45 S.E.C. 889 (1975), we concluded that a firm of accountants that had relied unduly on management representations concerning the collectibility of delinquent leases, "failed to use due professional care in that it did not sufficiently extend its audit tests by obtaining . . . adequate, competent, evidential matter to determine the veracity of management's representations."[54] Also, in Stephen Kutz, Exchange Act Rel. 27, Acctg. and Audit. Enf. Rel. No. 127 (Jan. 28, 1987), [1982-1987 AAER Transfer Binder], Fed. Sec. L. Rep. (CCH) 73,527, at 63,389-29, we advised that, "[w]here the audit evidence is inadequate or suspect, the auditor must exercise an increased degree of professional skepticism." Accordingly, under all the circumstances, we

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[53] Id. at 571, 573, 583. We found that the auditor "did not require production of any further documentary or further corroborating evidence relevant to the assertion" that the shares should not be treated as outstanding. Id. at 573. We accordingly concluded that the auditor "placed undue reliance on management representations," and, "in failing to make additional inquiry, failed to exercise sufficient professional skepticism and obtain adequate competent evidential matter relevant to the issue as required by GAAS." Id. For these and other failures, the auditor consented to a twelve-month suspension from practice before us.

[54] We also commented that the accountants had failed to evaluate "documentation" where it was available. Id. at 890. See also Norman Abrams, 49 S.E.C. 753, 757 (1988) (sanctioning, on consent, accountants for failing to gather competent evidential matter on a wide variety of issues and for accepting "without appropriate professional skepticism, undocumented representations of [the company's] management").

conclude that the requirements process have been amply met in this proceeding.[55]

VIII.

Potts makes various allegations of procedural impropriety, which we determined to reject. He contends that the law judge's determination to exclude the testimony of Roberta Karmel, who is not an accountant, was improper, and proffers that Ms. Karmel would have testified that the role and responsibilities of the concurring partner have not been clearly by this Commission. A decision to exclude such testimony was the law judge's discretion, and we believe it was proper. Mere opinion on the law such as that to be offered by Ms. Karmel would not provide evidence under Rule 14(a) of our Rules of Practice.[56]

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[55] We reject Potts' claim, made in reliance on Upton v. SEC, 75 F.3d 92 (2d Cir. 1996), that this proceeding is an attempt to sanction him pursuant to a substantial change in our enforcement policy that we have not communicated to the public. Nor can we agree with the dissent's suggestion that the standards that we discuss and apply here may very well not be the standards in place when Potts performed his Kahler audit work. The dictates of GAAS and GAAP themselves, with their attendant requirements, determine whether Potts engaged in improper professional conduct as a concurring partner. Here we are evaluating Potts' conduct against well-established professional and auditing standards relating to the conduct of auditors that were promulgated long before this respondent assumed his audit responsibilities. In so doing, we are not holding that Potts was obligated to "insure" the accounting treatment here.

[56] Former Rule 14(a) provides that a hearing officer shall receive relevant and material evidence, but should exclude irrelevant evidence. 17 C.F.R. 201.14(a) (1994). The testimony of expert witnesses on questions of law may be precluded, because adjudicators -- courts and administrative law judges -- are themselves qualified to determine and interpret the law. See, e.g., United States v. Bilzerian, 926 F.2d 1285. 1294 (2d Cir.), cert. denied, 502 U.S. 813 (1991).

Potts also claims that the law judge improperly relied on settlements entered by others implicated in this matter as indicia that Potts had acted improperly.[57] The law judge's references to these settlements were not improper, as they were not a basis for establishing Potts' liability. The reference to our settlement with Melsen, for instance - like that included early in this opinion[58] -- explained why Melsen is not a party to this action. Moreover, we do not agree that the law judge considered the settlement arising from Potts' earlier conduct as an engagement partner in deciding liability. Rather, the law judge considered that settlement in fashioning a sanction.[59]

We now turn to Potts' claims that the law judge prejudged the outcome in this matter and was prejudiced against him. Our de novo review of this leaves us convinced -- despite the law judge's unfortunate reference charging decision [60]-- that the law judge's conclusion that Potts engaged in improper professional conduct rested not on our decision to institute proceedings, but on the evidence received at the hearing.

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[57] The law judge noted in his opinion that Kahler, its officers, and Melsen had settled with this Commission. The law judge also noted that Potts had been the engagement partner on an audit which resulted in settled Rule 2(e) proceeding against the audited company and Touche.

[58] See note 7 supra.

[59] The use of a prior settlement for such a purpose is well-established by our precedents and, in any event, has little significance here, as we have determined to impose a lesser sanction than that imposed by the law judge. Compare, e.g., Belton v. Fibreboard Corp., 724 F.2d 500, 505 (5th Cir. 1984) (admitting evidence of settlements for purposes other than proving liability or the amount of damages does not contravene Rule 408 of the Federal Rules of Evidence).

[60] We refer to the law judge's statement that "even if there was some indication that Potts acted in good faith, it is irrelevant to the issue to be determined in this case. . . . [I]f Potts had merely made an error of judgment or had been careless, it is unlikely that the Commission would have considered him an appropriate subject for professional discipline."

Potts also contends that the law judge impermissibly shifted the of proof to him. The law judge did not. The statements to which Potts points merely suggest that the law judge found the Division's witnesses credible and that, as a result, the Division had presented a prima facie case against Potts.[61] The burden of persuasion remained with the Division. Although we do not consider the law comments improper, we have weighed the evidence and find that the Division has proven its case by a preponderance of the evidence. We are convinced that the law judge permitted Potts to put on the evidence he wished to defend and to defend himself fully,[62] that Potts was accorded a fair hearing, and that the law judge's decision was not the product of bias. Moreover, we have engaged in extensive de novo review in this case, dissipating the possibility of bias.[63] In sum, we

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[61] Compare, e.g., Donald T. Sheldon, 51 S.E.C. 59, 77 (1992), aff'd, 45 F.3d 1515 (11th Cir. 1995) (burden of defending pricing of securities shifted to respondents following presentation of evidence that it was fraudulent).

[62] While counsel urges that we find bias from the fact that the law judge brusquely interrupted counsel's cross-examination of a Division expert witness to direct, in effect, that counsel's questioning be kept brief and focused, the law judge permitted counsel to conduct a cross-examination of significant length.

[63] Potts reasonably objects to the law judge's finding that Milner was "more credible" than Potts in testimony as to why Kahler's financial statements did not identify the UPH as the asset held for sale. Milner in fact had not offered an explanation the law judge mistakenly attributed to Milner the explanation that Commission counsel, in a question put to Potts, had offered on the point.

We, however, reject as without, variously legal or record support, Potts' additional arguments, including that (1) we engaged in selective prosecution in bringing this action against him; (2) the staff advocated strict liability in arguing that a violation of GAAS and GAAP is improper professional conduct; (3) the law judge erred in not permitting Potts to depose Walter P. Schuetze, then our Chief Accountant, concerning Mr. Schuetze's views that existing standards for concurring partner review

have reviewed with care Potts' claims of bias as against the fairness and reasonableness law judge's evidentiary rulings and factual and legal conclusions. In our view, this remedial action properly may be based on the record as developed before the law judge.

IX.

Potts contends that the suspension ordered by the law judge is excessive. Under all the circumstances, we believe that the appropriate response to Potts' improper professional conduct is a nine-month suspension from practice before us. This proceeding brings into sharp focus the consequences of a concurring partner's failure to fulfill his or her professional responsibilities. Potts' actions evidence a lack of sensitivity to his obligations as an accountant concurring in the release of unqualified audit opinions on financial statements reviewed by public investors. Given Potts' long experience in the accounting profession, he may return to that profession and again conduct concurring partner reviews. A suspension is necessary to impress upon him the need to exercise due care

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should be strengthened; and (4) the location of the hearing -- on four days out of eight -- in a Commission conference room rather than a public meeting room rendered the hearing nonpublic in violation of the Administrative Procedure Act. We also deny Potts' motion to take Mr. Schuetze's deposition.

Pursuant to Rule 18 of our former Rules of Practice, we have determined to accept all briefs filed by the parties in connection with this matter. We will not make a part of this record -- nor have we considered the parties' filings with respect to the contents of -- the AICPA's October 1994 letter to Chairman Levitt. This letter was an ex parte communication. The AICPA failed to seek leave either to be heard before the hearing officer, as our former Rules of Practice permit (Rule 9(c) and (f), 17 C.F.R. 201.9(c) and (f) (1994)), or to file with us an amicus brief -- the appropriate vehicles for addressing the Commission concerning matters in litigation.

and professional skepticism, and to comply her essential standards of his profession when he conducts views and engages in other conduct as an accountant.

An appropriate order will issue.[64]

By the Commission (Chairman LEVITT and Commissioner HUNT); Commissioner JOHNSON concurring; Commissioner WALLMAN dissenting.

Jonathan G. Katz
Secretary

Commissioner JOHNSON, concurring:

I concur in the majority's judgment that Robert D. Potts engaged in improper professional conduct. See Commission Rule of Practice l02 (e)(ii). I write separately to emphasize several points.

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[64] All of the contentions advanced by the parties have been considered. They are rejected or sustained to the extent that they are inconsistent or in accord with the views expressed herein.

In Checkosky & Aldrich, a case in which Commissioner Wallman did not participate, I dissented from the opinion of two commissioners who held negligence may be a sufficient basis for liability under Rule 102 (e) -- in my view, scienter is required to establish a violation of Rule 102(e). See Exchange Act Release Rel. No. 38183 (Jan. 21, 1997), 63 SEC Docket 1948, 1975-77 (dissenting opinion). As reflected in his dissenting opinion in this case, Commissioner Wallman concurs that mere negligence is insufficient for liability under Rule 102 (e)(1).[1] The current Commission is thus evenly split two-two on this issue.

My view on the outcome of this case differs from Commissioner's because I believe that Potts acted with scienter. Commissioner questions whether sufficient guidance on the question of concurring responsibilities existed at the time of Potts' conduct. While I acknowledge that there may not have been an abundance of authority on the subject at that time, I believe that professional standards and requirements applicable to all accountants required Potts to exhibit a degree of care than he did. Under existing accounting standards, a concurring partner -- like any accountant -- has, at a minimum, an obligation to make "an objective review of significant accounting, auditing, or reporting considerations."[2] Moreover, GAAS requires that accountants obtain "[s]ufficient competent evidential matter" to afford a reasonable basis for an opinion.[3] Potts did not meet these standards.

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[1] See infra text accompanying dissent note 1. Commissioner Wallman believes that a pattern of negligent behavior demonstrating incompetence, for instance, may satisfy Rule 102(e)(1). I continue to adhere to the view I expressed in Checkosky that only improper professional conduct committed with scienter is sufficient.

[2] SECPS Manual at 1.

[3] AICPA AU § 150.02, Standards of Field Work, ¶ 3.

What is plain is that Potts clearly had notice of irregularities in accounting for the University Park Hotel and that he failed to require the engagement partner to support the accounting treatment used. Underscoring Potts' work here was the importance of the accounting treatment of the hotel in the overall context of the Kahler audits. The decision to capitalize losses flowing from the hotel, as opposed to treating them as losses and expensing them, was not a peripheral accounting issue, but instead a primary focus of the audit. Under any accounting standard, Potts was required to do more than simply recognize that irregularities in the audit existed; he was obligated to go further to assure that the accounting treatment used had an adequate basis. Potts' failures allowed Kahler to overstate net income and understate net losses for those two years in a material way.

In light of Potts' conduct and his probable future practice before the Commission, a sanction here is warranted. I agree that a nine-month suspension from practice before the agency is consistent with past

Commissioner WALLMAN, dissenting:

I. Introduction

The majority of the Commission affirms the law judge's finding in this case that Mr. Potts, a concurring partner for audits of Kahler Corporation in fiscal years 1988 and 1989, engaged in improper professional conduct under Rule 102(e)(1)(ii) (the "Rule") of the Commission's Rules of Practice. As a result, Mr. Potts has been suspended from practicing before the Commission for nine months.

This case raises, once more, the issue of the appropriate standard to by the Commission in connection with taking action under the Rule. I write separately to express my views on that increasingly ambiguous matter. In addition, the

majority finds that Mr. Potts was reckless with regard to his actions as a concurring partner on the Kahler audit. I dissent from that finding. It is not possible to reach that conclusion based on the record before us as to the standards that existed regarding the required conduct, almost a decade ago, of concurring partners.

II. Summary

The opinion of two of the Commissioners describes why Kahler's accounting treatment of, among other things, the University Park Hotel, was accordance with Generally Accepted Accounting Principles (GAAP) and audits were subsequently faulty. I agree that Kahler's accounting was faulty. I also agree that the audit was poorly crafted and not in conformance with Generally Accepted Auditing Standards (GAAS). I further hat the engagement partner did not comply with GAAS, and that Mr. Potts' actions as concurring partner did not prevent these audit failures.

I find, however, that the lack of clarity regarding the standard for concurring partners in 1988 and 1989, combined with this record -- and its infirmities -- provides insufficient information to allow a determination as to whether Mr. Potts was reckless or negligent (or perhaps even something less) in connection with his concurring partner duties in this audit. Consequently, I dissent from that finding of recklessness, it is necessary for me to reach the issue of whether mere negligence, or even no culpable state of mind, is sufficient for an action under the Rule.

As more fully described below, our inquiry in actions under the Rule must be focused on the fitness of a professional to continue to practice before the Commission. Accordingly, I believe the minimum standard for action under Rule 102(e)(1)(ii) must be something more than mere or simple negligence. An act of mere negligence, or less, simply

does not threaten the Commission's processes in a manner that should permit the Commission to take action under the Rule. To act in such a case evidences a desire to punish negligence or an error, not to protect the Commission. The securities laws provide remedies for wrongful actions, and sometimes there is liability for behavior that is negligent (or under certain strict liability provisions, for behavior that is wrong, even where there is no negligence).[1] The Rule, by contrast, is designed to protect the Commission's processes on a prospective basis. Transforming it into another arrow in the quiver of available remedies whenever anything goes wrong is, in my view, unwise over the long term. It will chill professionals in the appropriate discharge of their duties, bias audits and professional judgments, increase costs, and result in lesser, not greater, professional involvement with difficult judgment calls. Ultimately, such actions will disserve the investing public.

I also believe, however, that the Rule is well designed to reach activities that do evidence an unfitness to practice before the Commission. Simply put, the Commission must be able to protect itself from the clear incompetence of incorrigibly inept professionals practicing before it, as from miscreants. Consequently, a pattern of negligence may rise to the level where a professional should not be permitted to practice before us. But that is different than saying that mere negligence could constitute unethical or improper professional conduct under the rule sufficient to bar a professional from his livelihood.

Consideration of a professional's mental state helps inform the decision as to whether it is appropriate for the Commission to protect its processes by taking action under the Rule. Past negligent acts (other than evidencing a pattern)

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[1] In those circumstances there generally are numerous limitations on the actions and protections for the defendants.

would not support a conclusion that action is appropriate. I make this point particularly mindful of the ease with which more difficult judgment calls made by a professional -- which subsequently prove to be incorrect -- might be improperly characterized as "negligence."

In sum, to support a suspension or bar of a professional under Rule l02 (e)(1)(ii), I believe a professional must have evidenced unfitness to continue to practice before the Commission. In other words, the professional must have acted such that (i) the behavior is known by the professional to be wrong (e.g., lacking in character or integrity, or unethical or improper) or the professional was reckless in not knowing that wrong, or (ii) the Commission can conclude that the professional will likely engage in such wrongful behavior in the future (e.g., a pattern indicating that the professional lacks the knowledge, competence or moral fiber to perform the responsibilities and duties expected of such a professional).

My respected colleague, Commissioner Johnson, would set the standard under Rule 102(e)(1)(ii) such that an action could be maintained only in instances where the professional's work is imbued with scienter. I would not necessarily raise the bar to that level because, as I have noted, there are instances where a pattern of negligence justifies action under the Rule.

III. The Standard for Action Under Rule 102(e)(1)(ii)

A. Negligence

Introduction. In Checkosky & Aldrich,[2] an opinion in which I did not participate, the Commission, in a two to one decision (Commissioner Johnson dissenting), articulated a

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[2] Exchange Act Release No. 38183 (Jan. 21, 1997), 63 SEC Docket 1948.

standard for action under 2(e)(1)(ii). In that case, the Commission stated that "Rule (ii) does not mandate a particular mental state and that negligent actions by a professional may, under certain circumstances, constitute improper professional conduct."

I believe the standard for actions under Rule 102(e)(1)(ii) can be satisfied by negligent actions only when such acts bespeak a pattern of incompetence. I explicitly reject any view that, for example, "mere negligence" is sufficient for action under the Rule. The language of Rule 102 (e)(ii), its history and its purpose all indicate that some form of behavior, recklessness amounting to knowing behavior, or a pattern of culpable behavior by a professional -- in each case behavior that amounts to a threat to our processes -- is required before the Commission can deny him or her the privilege of practicing before it.

Rule 102(e)(1)(ii) states:

The Commission may censure or deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the Commission after notice and opportunity for hearing in the matter:

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(ii) To be lacking in character or integrity or to have engaged in unethical or improper professional conduct;

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Rule 102(e)(1) was first enacted by the Commission shortly after its creation in 1934. The Rule was part of the Commission's Rules of Practice promulgated under the

Commission's general rulemaking powers.[3] In its original incarnation, the rule provided that the Commission, in its discretion, could "suspend or disbar, any person who does not possess the requisite qualifications to represent others, or who is lacking in character, integrity, or proper professional conduct." The current language of Rule 102(e)(1)(ii) was enacted by the Commission in 1946.[4] The Commission's authority to adopt and administer the Rule has held by the federal courts including the Second Circuit Court of which found that the Rule "provides the Commission with the means to ensure that those professionals, on whom the Commission relies heavily in the performance of its statutory duties, perform their duties diligently and with a reasonable degree of competence."[5]

The Rule was promulgated to protect the integrity of the Commission's processes.[6] It addresses the problem of professional misconduct, "and its sanction is limited to that necessary to protect the investing public and the Commission from the future impact on its processes of professional misconduct."[7] As the Commission recognized in Carter & Johnson, "Not every violation of law . . . may be sufficient to justify invocation of the sanctions available under Rule 2(e).

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[3] Exchange Act Release No. 17597 (February 28, 1981), 22 SEC Docket 292.

[4] Securities Act Release No. 3154 (Sept. 4, 1946). In 1970, the Commission added a third prong to the rule, specifically addressing "willful" violations of the federal securities laws as a basis for denying professionals the privilege of practicing before the Commission. Amendment of Rule 2(e) of the Rules of Practice, Securities Act Release No. 5088 (Sept. 24, 1970).

[5] Touche Ross & Co. v. SEC, 609 F.2d 570 (2d Cir. 1979). See also, cases cited in Carter & Johnson; Checkosky & Aldrich .

[6] See Carter & Johnson.

[7] Id. at 297.

The violation must be of a character that threatens the integrity of the Commission s processes in the way that the activities of unqualified or unethical professionals do."[8]

Notwithstanding the Rule's over sixty-year life, until the Checkosky & Aldrich opinion, the Commission has never stated that mere negligence was sufficient to sustain an action under Rule 102(e)(1)(ii)[9]. And with this case, the Commission now no longer can sustain that holding -- at the very least it is split evenly on that issue -- as both Commissioner and I explicitly believe that mere negligence is insufficient, with Commissioner Johnson requiring scienter.

Language of Rule 102(e)(1)(ii). The issue in these cases focuses on the term "improper professional conduct" in Rule 102(e)(1)(ii), as if that term stands alone. But "improper professional conduct" does not stand alone. As it is used in the Rule it is inextricably intertwined with "unethical" conduct, as well as with the phrase "lacking in character or integrity." Unlike, for example, different sections of a statute as in Aaron v. SEC, [10] or even different subsections of a rule

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[8] Id. at 298.

[9] The Commission never rendered a decision in Danna and Dentinger v. SEC, No. C-93-4158 (N.D. Cal. Feb. 8 1994), and the reviewing court held only that the Commission s authority under the Rule is not limited to cases of bad faith or intentional misconduct -- a view to which I also subscribe.

[10] 446 U.S. 680 (1980). My analysis is consistent with the Supreme Court's analysis in Aaron. In analyzing section 17 of the Exchange Act, the Court was analyzing separate subsections of the statute, not words within the same prong of a rule. More importantly, the Aaron Court distinguished, as do I, between the effect of the particular conduct on the public -- as I will discuss below -- versus the culpability of the person responsible and the effect of the professional's behavior (which can include the professional's state of mind) on the Commission's processes. The entirety of the second prong of Rule 102(e)(1) focuses on the actions of the professional as they relate to the Commissions processes, including when such actor engages in improper professional conduct.

-- here we interpreting the words in but one prong of one rule. Unethical includes an element of bad faith and thus some form of intent on the part of the actor, as do issues relating to character or integrity. One does not negligently have bad character, lack integrity or act unethically. Reading "improper" outside the clear context of the rest of the words in this prong of the Rule would mislead as to its meaning.

Simply put, prong two uses three terms that clearly include some sense that son is a bad actor; it would be odd then to interpret the fourth - same prong and linked to the other three -- to embody a different standard.[11] Mere negligence in satisfying generally accepted auditing standards, unless it bespeaks a pattern of incompetence, clearly does not fit.

Purpose of Rule 102(e)(1)(ii). As noted, the Rule was promulgated by the Commission "in order to protect the integrity of its processes."[12] If a person commits a merely negligent act, it will not necessarily raise any threat to these processes. A past negligent act may, of course, cause a financial statement to be misleading, or an opinion of counsel to be inaccurate, as can a completely innocent mistake. However, a past wrong informs a conclusion that there exists a threat to the Commission's future processes, it is not proper to utilize the fact that there is an impact from that wrong to justify taking action under the Rule.

If we sanction under the Rule by focusing on the effect of past acts, why require the professional to have acted

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[11] As used in this prong, unethical and improper are, I believe, intended to be relatively consistent as to their reach. In any event, there clearly is sufficient ambiguity as to what "improper" means -- with two of the current four Commissioners taking a position different from that of the other two -- that resort to the surrounding context for assistance in interpreting its meaning is obviously important.

[12] See Carter & Johnson

negligently at all -- why not concentrate just on the impact and make it clear that any act that results in a material misstatement is obviously "improper" and will be actionable? The public is harmed, the Commission's and the statute's intricate balance of disclosure and investor reliance are all upset, with costs visited on investors and our whole system of capital formation just as surely by a disclosure that is materially inaccurate or a financial statement that is materially misstated because of non-negligent mistakes as by negligent or intentional ones. The answer, of course, is obvious. The Rule, and for good reason, does not provide liability and some punishment when an ate disclosure is made by a covered person because of the impact of the act on public filings. Rather, it is designed to protect the Commission's processes from future harm that would result from continuing professional misconduct.

Merely negligent actions by a professional years ago do not present any realistic threat to the Commission's future processes today. Yet, under the standard articulated in Checkosky, any act of negligence supports a conclusion that a professional presents a threat to the Commission. It is hard to perceive where a line will be drawn with respect to a professional who makes a negligent mistake. Presumably, under this standard, there will always be -- almost by definition -- a similar threat to the Commission's future processes whenever negligence, or any mistake, exists. Something more is needed to guide professionals and to inform the Commission when action under the Rule is appropriate; standards must have substance for them to be meaningful. As the Commission in Carter & Johnson noted, "It is that element of [wrongful] intent which provides the basis for distinguishing between those professionals who may be appropriately considered as subjects of professional

discipline and those who, acting in good faith, have merely made errors of judgment or have been careless."[13]

The securities laws and regulations, and particularly the accounting rules that must be interpreted and applied by professionals, are complex. Reasonable people differ on the interpretations of those laws and regulations. Professionals must have some flexibility to exercise their judgment in difficult situations. They should not be subject to action under Rule 102(e)(1)(ii) for making an incorrect decision -- especially one that would characterize as "negligent" or "merely negligent." My colleague Commissioner Johnson stated this thought quite aptly in his dissent in Checkosky where he wrote:

> A professional often must make difficult decisions, navigating rough complex statutory and regulatory requirements, and in the case of accountants, complying with Generally Accepted Auditing Standards ("GAAS") and applying Generally Accepted Accounting Principles ("GAAP"). These determinations require the application of independent professional judgment and sometimes involve matters of first impression. For this reason, I believe that an earlier Commission was correct to assert that, if a professional is to exercise his or her best independent judgment . . . [the professional] must have the freedom to make innocent -- or even, in certain cases, careless -- mistakes without the fear of [losing] the ability to practice before us.[14]

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[13] This statement from Carter & Johnson is made within the section of the opinion discussing aiding and abetting in prong (iii) of the Rule. I believe this statement underscores the purpose of the Rule generally.

[14] Checkosky at 1976 (citations and footnotes omitted).

I concur with Commissioner Johnson's statement: "I simply do not believe that we should recast negligent violations of an accounting standard as improper professional conduct under the Commission's Rules of Practice."[15]

B. Scienter

Constituting Scienter. For the above reasons, I believe the minimum standard for improper professional conduct under Rule 102(e)(1)(ii) is behavior that is known by the professional to be wrong (or the professional was reckless in not knowing that it was wrong) or that supports a conclusion by the Commission that the professional will likely engage in such wrongful behavior in the future. Consequently, I do not believe the includes only actions imbued with scienter. Clearly, scienter, which could be satisfied by reckless behavior, is sufficient to take action under the Rule. As the majority opinion notes, recklessness is "not merely a form of ordinary negligence; it is an extreme departure from the standards of ordinary care, which presents a danger of misleading buyers or that is either known to the defendant or is so obvious that the actor must have been aware of it."[16] This type of behavior is obviously a danger to the Commission's processes.[17] However, the issue is not one of

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[15] Id. at 1977.

[16] Opinion at n.40 (citations omitted).

[17] It might be argued that an act of mere negligence presents a similar threat to the Commission's processes on a theory that a professional whose negligence has been discovered on one occasion is more likely to make other negligent mistakes in the future than a professional whose record is unblemished. However, as the culpability associated with a particular act increases, the likelihood that a professional might act similarly in the future -- and thus threaten the Commission s processes -- also increases. Reckless conduct, including, for example, conduct occurring several years ago, could support Commission action under the Rule, as such conduct

negligence versus scienter. Rather, the issue is whether the individual has the professional fitness to continue to practice before the Commission.

For example, there may be situations in which a pattern or series of negligent acts rises to a level that warrants Commission action under Rule 102 (e)(1)(ii). Depending on the specific circumstances, where a professional commits a negligent act, is made aware of the negligence or mistake and repeats the same or similar act, such repeated negligence should make the person aware that they are incompetent to continue performing in this professional capacity. Continuing to act with such awareness may rise to the level of recklessness. But even if it does not, the Commission must be able to protect itself from the clear incompetence of incorrigibly inept professionals practicing before it. But saying that a pattern of negligence could rise to the point where a professional should be barred or suspended from practice before us is very different from adopting a standard that a single act of negligence can be deemed unethical or constitutes improper professional conduct sufficient under the Rule to preclude a professional from pursuing his livelihood.

IV. Other Concerns

Prosecutorial Discretion. As a matter of policy, the Commission could make standard for Rule 102(e)(1) as low as possible and then exercise prosecutorial discretion in determining when to suspend individuals from practicing before it. I believe that to do so, however, would confuse the

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bespeaks a callousness regarding, and a willingness to disregard, basic principles of duty and care. As I indicate later in this dissent, the Commission could modify its Rules of Practice if it makes the determination that it must protect its processes against mere negligence; but, Rule 102(e)(1)(ii), as presently written, does not encompass such negligence.

prosecutorial function of the Commission with its adjudicatory obligations. Certainly, from a prosecutorial standpoint a lower standard is better, enabling the Commission to be flexible and exercise its discretion. In our adjudicatory role, however (as we are acting here), the Commission is charged with interpreting and applying the law. We need to act as impartial judges blind to our role as prosecutor -- not as advocates for our prosecutorial function.

Distinctions Between Accountants and Other Professionals.

Separately, I also find very troubling the notion that the Commission applies different standards for actions under Rule 102(e)(1) to accountants as compared to attorneys. The Commission has generally refrained, as a matter of policy, from using Rule 102(e)(1) to make determinations regarding the professional obligations of attorneys. As a result, Rule 102(e)(1) proceedings against attorneys have generally arisen only where the attorney's conduct has already been adjudicated to violate the law, almost exclusively by federal courts in non-Rule 102(e)(1) proceedings.[18] These cases, since the decision in Ernst & Ernst v. Hochfelder,[19] must generally involve knowing or reckless conduct by the attorney involved. As a result, a negligence standard under the "improper professional conduct" provision of Rule 102(e)(1) would likely be the basis for such an action against attorneys. Under the opinion of my colleagues in Checkosky and Aldrich, however, for accountants GAAP and GAAS standards to adhere to, the Commission could bring a case based on negligence in the violation of those standards, finding that the behavior constituted "improper professional

[18] Id.

[19] 425 U.S. 185 (1976).

conduct." I do not believe a legitimate reason for such a dramatic distinction.

Rulemaking. Finally, I note the obvious: Rule 102(e)(1) is a Commission rule. Clearly it is sufficiently vague that reasonable minds - and have differed -- strongly about the standards applicable to actions under its terms. Notably, the Commission is now either moving away from its recent holding in Checkosky and Aldrich, or split evenly on this precise issue. If the Commission believes that mere negligence should be the basis for denying a professional the privilege of practicing before it, the Commission should amend its own Rule to make the standard clear. It is unfair to the professionals practicing before the Commission, and an enormous waste of Commission resources, to be unable to discern from the face of our rules what standards are to be applied. I find it extremely strange that this debate is pursued in the context of opinions in enforcement proceedings as opposed to in a rulemaking where the Commission can state its own mind clearly, after notice and comment and due reflection issues, and without the press of individual professional careers, and audit failures, at stake. Why don't we propose to amend the Rule if we believe mere negligence is sufficient? Today, we send no clear message, other than that two of us believe mere negligence is insufficient. We now address this matter through rulemaking.

V. The Standard for Concurring Partner Review

Assuming the standard for liability is one of recklessness, the majority finds on the record before us that Mr. Potts' actions satisfied that standard. I cannot agree because the lack of clarity as to the standard of conduct for concurring partners during the relevant time combined with this record, does not allow us to make this finding.

Mr. Potts was a concurring partner in 1988 and 1989. He acted in this capacity only because, as a member of the SEC Practice Section of the American Institute of Certified Public Accountants, Deloitte and Touche required a concurring partner for SEC engagements, such as the Kahler audits.[20] As concurring partner, Mr. Potts was to provide a second level of review affording "additional assurance" that the company's financial statements were presented in accordance with GAAP and that the audit procedures were conducted in accordance with GAAS.[21] The AICPA's SECPS Manual provided, at best, guidelines for concurring partner review but the record does not indicate whether there were any standards for this "additional assurance" in the late 1980s, and if so what they were. Was it to review the audit in detail, or perhaps ask some questions to assure that the engagement partner was attempting to comply with GAAS, or was it something more or something less? The SECPS Manual guidelines included reading the financial statements and the audit firm s report thereon, and making an objective review of significant considerations, along with discussing such matters with the engagement partner and reviewing selected work papers. All this, Mr. Potts did. He might not have done it as well as we might like -- but he did do it. Did he do it so poorly that his actions were reckless -- or merely negligent or something less? The opinion of two of the Commissioners cites to general literature as to the obligations of auditors and the requirements for an auditor, such as the engagement partner, in connection with performing an audit under GAAS. These requirements are clear and not controverted. But the opinion confuses the obvious. Of course auditors are to exercise due care, evaluate properly and employ professional skepticism. This applies to all auditors everywhere, including those in the

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[20] See opinion at n.1.

[21] Id.

national offices and on other audits. So what? The issue is what was a concurring partner on an engagement in 1988 and 1989 supposed to be doing in the context of this audit for the Kahler Corporation being run by a presumably competent engagement partner in one of the nation's respected accounting firms. Specifically, what is unclear and controverted is what precisely were then obligations of the concurring partner -- not the engagement partner -- in concurring with respect to an audit. The majority cannot say what they were, because there is no answer in the record.

The opinion of two of the Commissioners cites expert testimony on the role of a concurring partner during the relevant period.[22] The experts address generally what they believe a concurring partner is meant to do. They all agreed that the general requirement for a concurring partner was to provide additional assurances. They all also concurred that there are no written standards specifying what this additional assurance requires on the part of the concurring partner (other than the general SECPS Manual guidelines noted above). In fact, one of the experts noted, in response to a question about why he was testifying, that he "felt that the profession would be enhanced if there were clarification of the requirements so that others in the profession would really understand what was intended by the SEC Practice Section rules on concurring "[23] Obviously, even when this expert recently testified, there was uncertainty in the area that needed clarification. If there is uncertainty in the profession now, as I understand there is, it seems fair to assume that even greater uncertainty existed in the late 1980s.

Understanding the applicable standard and practice today, one could conclude that Mr. Potts' mistakes were negligent. Some, including the ALL majority, conclude that these

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[22] See Opinion at n.27.

[23] Testimony of Donald Moulin, Transcript at p. 752.

mistakes amounted to recklessness. But without knowing the applicable standard almost ten years ago, it is not possible to tell what they were then.[24]

In sum, in order to resolve this case fairly, either it should be returned to a different ALL for further development of the record,[25] or the parties should be given a further opportunity to briefs or testimony on the specific issue of concurring partner in 1988 and 1989.[26]

For the above reasons, I respectfully dissent from the majority's assertion that Mr. Potts was reckless.

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[24] The opinion of two of the Commissioners asserts that Mr. Potts did something wrong and there were "red flags" so he must have engaged in improper professional conduct and been reckless. See Opinion text accompanying n.39. But reckless compared to what standard? Again, clearly, the audit went badly awry. Clearly, the engagement partner failed to comply with GAAS. Clearly, Mr. Potts did not prevent that and he made a mistake by either not recognizing the red flags, or not pursuing them vigorously enough. But since we don t know exactly, or even somewhat broadly, what was expected of a concurring partner almost a decade ago, it is hard to tell how egregious these errors were. If a concurring partner was supposed to repeat the audit, then clearly this behavior was reckless. If a concurring partner, at that time, was supposed to ask questions to obtain a feel for whether the audit was being performed correctly, but not much else other than to comply with the cursory statements in the SECPS Manual, then Mr. Potts' actions hardly constitute negligence. The majority concludes recklessness. But without certainty as to what the standard was, I see no basis for such a belief.

[25] I am troubled by statements of the ALL such as: "[I]f Potts had merely made an error of judgment or had been careless, it is unlikely that the Commission would have . . . [brought the case]." See Opinion at n.60. Such a statement makes me question, strongly, the record as a whole on which we rely.

[26] The opinion of two of the Commissioners suggests that I infer that relevant standards have evolved since the audits were conducted. Opinion at n.27. I intend no such inference, but merely believe the record does not contain sufficient evidence to support an assumption that these standards have not changed over the relevant time period.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 39126 / September 24, 1997

ACCOUNTING AND AUDITING ENFORCEMENT
Rel. No. 964 / September 24, 1997

Admin. Proc. File No. 3-7998

In the Matter of

ROBERT D. POTTS, CPA
c/o Briggs and Morgan
2400 IDS Center
Minneapolis, MN 55402

ORDER IMPOSING REMEDIAL SANCTIONS

On the basis of the Commission's opinion issued this day, it is

ORDERED that Robert D. Potts, CPA, be, and he hereby is, suspended from practice before the Commission for a period of nine months, to be served beginning October 6, 1997.

By the Commission.

Jonathan G. Katz
Secretary

Supreme Court, U.S.
FILED
APR 1 1999

(2)

No. 98-1058

In the Supreme Court of the United States

OCTOBER TERM, 1998

ROBERT D. POTTS, PETITIONER

v.

SECURITIES AND EXCHANGE COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION IN OPPOSITION

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18pp

QUESTION PRESENTED

Whether substantial evidence supports the finding of the Securities and Exchange Commission that petitioner, a certified public accountant, failed to comply with applicable professional accounting and auditing standards while he was acting as the concurring partner in an audit.

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In the Supreme Court of the United States

OCTOBER TERM, 1998

No. 98-1058

ROBERT D. POTTS, PETITIONER

v.

SECURITIES AND EXCHANGE COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A-1 to A-7) is reported at 151 F.3d 810. The opinion and order of the Securities and Exchange Commission (Pet. App. A-9 to A-61) are reported at 7 Fed. Sec. L. Rep. (CCH) ¶ 74,479.

JURISDICTION

The judgment of the court of appeals was entered on August 4, 1998. A petition for rehearing was denied on September 30, 1998 (Pet. App. A-8). The petition for a writ of certiorari was filed on December 28, 1998. The

jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner, a certified public accountant, was a partner at Touche Ross & Co. and its successor firm Deloitte & Touche (Touche). Pet. App. A-2. While at Touche he served as the concurring partner for the 1988 and 1989 audits of Kahler Corporation, a publicly held company which owns and manages hotels. *Id.* at A-2, A-10. As concurring partner, petitioner's responsibility was to provide a second-level review of Kahler's audits and thus to afford further assurance—that is, assurance in addition to that given by the engagement partner, who led the audit team—that Kahler's financial statements conformed with generally accepted accounting principles (GAAP) and that the audits were conducted in accordance with generally accepted auditing standards (GAAS). *Id.* at A-2 to A-3. The responsibility was an important one. Under guidelines issued by the SEC Practice Section (SECPS) of the American Institute of Certified Public Accountants (AICPA), an audit report on a publicly held company may not be released unless a concurring partner reviews the report and agrees that the audit was conducted in accordance with GAAS and that the company's financial statements conform to GAAP. *Id.* at A-10 to A-11 n.1. Because Touche, like all the major accounting firms, is a member of the AICPA, Kahler's audit reports could not have been released without petitioner's concurrence.

Petitioner concurred in Touche's unqualified audit reports on Kahler's financial statements for both 1988 and 1989. Pet. App. A-3. Both financial statements accounted for, among other things, a Kahler property

known as the University Park Hotel (Hotel). *Id.* at A-2. The Hotel lost money both years, and for each of those years Kahler accounted for the Hotel as an asset held for sale. *Ibid.* That treatment of the Hotel allowed Kahler to factor the Hotel's losses into the Hotel's carrying value rather than deducting those losses from Kahler's current income. *Ibid.* As a result, Kahler posted a net gain instead of a $1.108 million net loss for fiscal year 1988, and a net loss of $1.842 million instead of a $2.808 million net loss for fiscal year 1989. *Id.* at A-14.

2. The Securities and Exchange Commission (SEC or Commission) subsequently conducted an investigation into Kahler's accounting treatment and financial statement presentation of the Hotel in 1988 and 1989, and into Touche's audits of those financial statements. Based on petitioner's performance in connection with the audits, an administrative law judge (ALJ) found that he had recklessly engaged in improper professional conduct in violation of SEC Rule 2(e)(1), 17 C.F.R. 201.102(e)(1). Pet. App. A-2, A-11. The ALJ suspended petitioner from practice before the Commission for a period of eighteen months. *Ibid.*

3. Petitioner appealed the ALJ's decision to the Commission, arguing, among other things, that both Kahler's accounting treatment of the Hotel and petitioner's conduct were proper, that the Commission had no authority to discipline petitioner, and that, even if it did, it failed to provide him with adequate notice of the standards by which his conduct would be judged. Pet. App. A-15, A-23, A-33, A-34. The Commission rejected those arguments. Reviewing the ALJ's decision *de novo*, the Commission agreed with the ALJ that petitioner had recklessly engaged in improper professional conduct. *Id.* at A-31 to A-33. The Commission did,

however, reduce petitioner's suspension from eighteen to nine months. *Id.* at A-41 to A-42, A-61.

The Commission found that Kahler's treatment of the Hotel as an asset held for sale was improper under GAAP. Pet. App. A-15 to A-19. GAAP, the Commission observed, permits a company to account for a property as an asset held for sale and to defer its losses only if the company satisfies a series of requirements. *Id.* at A-15. Those requirements include, among other things, that the company have a formal plan to sell its entire interest in the property, and that it determine that the sale of the property will result in a net gain after considering any unreported losses. *Ibid.* The Commission found that Kahler failed to satisfy these requirements because (1) Kahler did not pursue an outright sale of the Hotel, but instead repeatedly sought investors only to share ownership of the Hotel with Kahler (*id.* at A-16 to A-17); (2) Kahler did not have a formal plan to dispose of the Hotel (*id.* at A-17 to A-18); (3) Kahler's management had no basis to conclude that the Hotel's selling price would make up for its operating losses because the management "failed to assess adequately the Hotel's net realizable value and failed to estimate the Hotel's operating losses to be incurred prior to sale" (*id.* at A-19); and (4) although Kahler's Board of Directors first authorized sale of an interest in the Hotel in mid-April 1988, Kahler treated the property as an asset held for sale from the beginning of that year. *Ibid.* Accordingly, the Commission concluded, Kahler's accounting treatment of the Hotel was improper under GAAP. *Id.* at A-15 to A-19.

The Commission also concluded that petitioner engaged in improper professional conduct when he concurred in Touche's audit report. Pet. App. A-20 to A-33. The Commission relied on the professional

standards described in the AICPA's Statements on Auditing Standards, expert testimony offered by both sides, the statement in the AICPA manual that broadly defines the concurring partner's role, and prior Commission decisions that had discussed the obligations of concurring partners. *Id.* at A-20 to A-23, A-34 to A-38. The Commission's analysis, it noted, was "shaped[] in part[] by [its] recognition of * * * [petitioner's] extensive professional experience and familiarity with Kahler's operations; [his] knowledge of the contents of the work papers * * *; and [his] knowledge that the accounting treatment utilized was material to the financial statements." *Id.* at A-23 to A-24. For several reasons, the Commission found that petitioner's conduct as concurring partner failed to comply with the standards set forth in these sources. *Id.* at A-24 to A-31.

To begin, petitioner concurred in the audit reports despite the absence of a formal plan to sell Kahler's entire interest in the property. Pet. App. A-24 to A-27. Indeed, the Commission pointed out, petitioner knew that the audit record contained documentary evidence showing that Kahler did not intend to sell the Hotel outright, but instead was attempting to dispose of a partial interest. *Id.* at A-24. When petitioner suggested that Gregory J. Melsen, the engagement partner for the Kahler audits, ascertain Kahler's actual intentions, Melsen obtained only unsubstantiated assurances from company management and the audit committee of the Board of Directors. *Id.* at A-25. Neither management's nor the audit committee's assurances negated or explained the contrary evidence, and neither was accompanied by any supporting documentation that might have done so. *Id.* at A-26. Even so, petitioner accepted Melsen's assurances that

Kahler had complied with the formal plan requirement and was in fact committed to selling its entire interest in the Hotel. *Id.* at A-26 to A-27.

Petitioner also concurred in the audit reports even though the audit record did not contain sufficient competent evidence to support a reasonable expectation of a net gain on sale of the Hotel. Pet. App. A-28 to A-30. The audit record for 1988 contained no reliable evidence of the Hotel's worth, while the record for 1989 contained a valuation by Touche's own Valuation Office of $11.4 million, far below the $16.75 million book value, and much less than was required to produce a net gain on sale of the Hotel. *Ibid.* In response, the audit team made "correct[ions]" to the numbers used in the Touche valuation, substituting Kahler's higher projections of future cash flow for the projections, based on historical results, that the Valuation Office had used. *Id.* at A-29 to A-30. These changes, the Commission pointed out, had the effect of increasing the purported value of the property, apparently "in an effort to demonstrate compliance with the requirements" for deferring the operating losses of the Hotel. *Id.* at A-29. Petitioner, again accepting Melsen's assurances, concurred in the reports without ever receiving explanations for the changes and despite his knowledge of the relevant facts, including "various documentation that * * * strongly cautioned against reliance on Kahler-generated projections." *Id.* at A-30. In addition, petitioner inexplicably agreed with treating the Hotel as an asset held for sale for all of 1988. *Id.* at A-30 to A-31.

The Commission ruled that in light of the total audit environment, including the keen significance to the financial statements of the Hotel-related loss deferrals and the heightened risk of material misstatement caused by Kahler's history of aggressive accounting,

petitioner's "deviations from the duties imposed by GAAP and GAAS constitute improper professional conduct." Pet. App. A-32. Petitioner, the Commission found, "acted recklessly in indicating, with respect to both audits, that he had reviewed the financial statements and concluded that they satisfied the standards of the profession." *Id.* at A-31 to A-32 (footnote omitted). The Commission defined recklessness as "not merely a form of ordinary negligence," but "an 'extreme departure from the standards of ordinary care, which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.'" *Id.* at A-32 n.40. The Commission emphasized that a concurring partner "provides important additional assurance" that GAAS and GAAP have been complied with, and that his or her role "is to provide substantially more than 'window dressing.'" *Id.* at A-32 to A-33. It further observed that petitioner's "substantial departures from his professional duties establishes that this Commission cannot rely upon [petitioner] to perform diligently and with reasonable competence his audit responsibilities." *Id.* at A-33.

The Commission also rejected petitioner's challenges to its authority to enforce Rule 2(e) (17 C.F.R. 201.102(e)) against him in this context. The Commission noted that the courts of appeals that have addressed the validity of Rule 2(e) have upheld the rule as "'reasonably related' to the purposes of the securities laws." Pet. App. A-34. As to petitioner's argument that he had no notice of the governing principles, the Commission pointed out that GAAS and GAAP are standards to which all accountants must adhere and which are "within [petitioner's] ready understanding." *Id.* at A-35. The Commission also explained that its

"opinions and orders in a range of settled matters" both have "provided guidance to the accounting profession as to the standards expected of concurring partners" (*ibid.*) and have "explored the nature of due care and professional skepticism * * * as these concepts relate to accountants generally." *Id.* at A-36. Thus, the Commission concluded, petitioner was not "without guidance as to appropriate professional standards." *Id.* at A-34.

4. Petitioner sought review of the Commission's decision in the court of appeals. He argued principally that substantial evidence did not support the Commission's findings of recklessness and of improper professional conduct, and that the professional standards governing concurring partners had not provided adequate notice of the performance expected of him. Pet. App. A-2, A-6.

The court of appeals affirmed the Commission's order in all respects. Pet. App. A-1 to A-7. The court found that substantial evidence supported the Commission's finding that petitioner recklessly failed to carry out his professional responsibilities. *Id.* at A-2 to A-6. It could reasonably be concluded, the court stated, that petitioner's conduct in approving the audits "based on Melsen's unprobed, untested representations" and in sanctioning the backdating of the asset for sale treatment to the start of 1988 amounted to an "egregious refusal to see the obvious, or to investigate the doubtful." *Id.* at A-5 (citing *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1426 (9th Cir. 1994), cert. denied, 516 U.S. 868 and 909 (1995)).

The court of appeals also rejected petitioner's assertion that he was denied due process because he did not have adequate notice of the standards of professional conduct for concurring partners that the Commission

applied to his case. Pet. App. A-6 to A-7. The court of appeals explained that "[t]he SEC did not invent new standards in this case." *Id.* at A-6. Rather, "the Commission evaluated [petitioner's] conduct in light of the well-established norms of the accounting profession," namely GAAP and GAAS. *Ibid.* The court of appeals observed that, while GAAP and GAAS do not require concurring partner review, such review is required by the major accounting firms for audits of publicly held companies. *Ibid.* The court of appeals explained that petitioner, "[h]aving taken on the concurring review task, * * * also shouldered the duty to perform that task professionally." *Ibid.*

As to the duties of a concurring partner, the court of appeals found that "[a]lthough a concurring reviewer is not expected to do the audit all over again, [petitioner's] own expert witness agreed that a concurring partner must evaluate the financial statements and audit in light of GAAP and GAAS." Pet. App. A-6. "To do so competently," the court of appeals stated, "the concurring partner must observe the commonsense principles the SEC applied here." *Id.* at A-6 to A-7. The court of appeals pointed out that "the SEC has consistently evaluated the professional conduct of concurring partners under GAAP and GAAS" and, by 1988, had issued several opinions and orders that specifically addressed the duties of a concurring partner or one performing an equivalent role under a different name. *Id.* at A-7. Thus, the court of appeals found, "[petitioner] had a reasonable opportunity to know what the SEC expected of him." *Ibid.*

ARGUMENT

Petitioner argues that he was suspended without due process because he did not have adequate notice of the

professional standards that the Commission applied (Pet. 13-22), and that the Commission exceeded its statutory authority by impermissibly promulgating new accounting standards for concurring partners under the guise of regulating improper professional conduct by those who appear before it. Pet. 22-29. The premise of these arguments fails, however, because, as the Commission explicitly found, petitioner recklessly failed to comply with the *established* professional standards for concurring partners. Pet. App. A-31 to A-33. In essence, then, petitioner is challenging the court of appeals' conclusion that the Commission's findings are supported by substantial evidence. The court of appeals' decision is correct and does not conflict with any decision of this Court or of any other court of appeals. Accordingly, further review is not warranted.

1. Petitioner does not deny that the Kahler accounting was improper for both years.[1] Instead, he claims that he may not be disciplined because the professional standards applied by the Commission were newly announced in this case, and that the Commission "imposed its sanction even though" petitioner's conduct complied with the "existing standards of the industry." Pet. i.

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[1] It is well-established, and petitioner does not dispute, that the Commission has the authority to promulgate Rule 2(e) as a means of protecting its processes from the harm that can be caused by professionals who deviate from the applicable professional standards. See *Touche Ross & Co.* v. *SEC*, 609 F.2d 570, 572-573 (2d Cir. 1979) (Rule 2(e) is an attempt by the Commission to protect the integrity of its processes, and is therefore an appropriate exercise of the Commission's rulemaking authority); *Sheldon* v. *SEC*, 45 F.3d 1515, 1518 (11th Cir. 1995) (same); *Checkosky* v. *SEC*, 23 F.3d 452, 455 (1994) (opinion of Silberman, J.) (same), following remand, 139 F.3d 221 (D.C. Cir. 1998); *Davy* v. *SEC*, 792 F.2d 1418, 1421-1422 (9th Cir. 1986) (same).

Petitioner even goes so far as to assert that his compliance with the existing standards is undisputed.[2]

Petitioner's arguments have no merit. In the words of the court of appeals, the Commission "did not invent new standards in this case," but instead evaluated petitioner's conduct "in light of the well-established norms of the accounting profession, collectively referred to as GAAP and GAAS." Pet. App. A-6. Petitioner was suspended because, as the court of appeals correctly pointed out, he did not observe the settled, "commonsense principles" that were to be used by the Commission in evaluating his performance. *Ibid.* Thus, the petition raises only the narrow issue of whether the Commission's application of established professional standards to petitioner's specific conduct should be upheld.

Petitioner mistakenly suggests that this case turns on his failure to take sufficient steps to discover the problems in the audits. Pet. 23-24. To the contrary, substantial evidence shows that petitioner knew of the problems in the accounting and in the audits. His improper professional conduct took place when he concurred in the audit reports despite the fact that these problems had not been adequately explained or resolved. See Pet. App. A-23 to A-31.

To ascertain the scope of petitioner's duties in applying GAAP and GAAS, the Commission looked

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[2] For instance, petitioner states that there were existing guidelines for a concurring partner to follow in 1989 and 1990, "and no one disputes that [petitioner] met those guidelines." Pet. 12; see also Pet. 13 (imposition of a sanction for "conduct that complied with industry * * * standards" calls for granting of review by this Court), 15 ("There is no question in this case that [petitioner] complied with the only guidance available to him on the role of the concurring partner.").

first to the AICPA SECPS Manual, which states that member firms must adopt the following "minimum" policies and procedures for concurring partner review:

> Reading the financial statements and the firm's report thereon and making an objective review of significant accounting, auditing, or reporting considerations. This review should be performed prior to the release of the report and should include discussions with the partner in charge of the engagement and review of selected working papers.

Pet. App. A-21.

These requirements were fleshed out by accounting experts called by both sides to testify concerning the professional standards with which all competent accountants should be familiar. Both the Commission and the court of appeals referred to the testimony of petitioner's own expert, Edward J. Kerans, on the concurring partner's responsibilities. Pet. App. A-6, A-24. Kerans compared the concurring partner to the last inspector at a car plant who looks at the final product before it goes out the door. When he was asked what the concurring partner would do if he kicks the tires and the car sways to the left abruptly, Kerans answered:

> He needs to investigate that. He needs to go back and see how that engagement management team dealt with that. So he would have to go back on the line and take it to the particular unit section and say that I've seen this issue, what is it that we've done about this. And so it's going to be pursued and investigated. * * * He has to become satisfied as to the resolution of that question.

Gov't C.A. Supp. App. 213.

When asked what steps he would take as concurring partner if he was not satisfied with the answers he received, Kerans replied that he would ask

> [a]dditional questions. * * * I'm going to have to become satisfied. * * * Before I basically clear the report, I will have to become satisfied. * * * The engagement partner has a responsibility to do that. In other words, he has to respond to my questions. If he has satisfied me in responding to those questions and I have no additional questions, I'll clear it. If he has not satisfied me and refuses to pursue it further, we're now in the area of a disagreement and Touche as well as Coopers & Lybrand has a policy for handling disagreements.

Gov't C.A. Supp. App. 214-215. One of the steps Kerans said he would take when acting as a concurring partner if he was not satisfied was to ask the engagement partner to provide him with further evidence. *Id.* at 215. Kerans also stated that the concurring partner has substantial responsibility, because he has to use his knowledge in the area in order to raise questions and then come to a conclusion whether or not the audit and financial statements meet GAAS and GAAP, and because a report on a public company will not be issued without the concurring partner's signature. *Id.* at 218-219.

The three experts called by the Commission gave testimony substantially similar to that of Kerans with respect to the professional standards applicable to a concurring partner.[3] Gov't C.A. Supp. App. 19, 78-80,

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[3] Petitioner's expert and the experts called by the Commission did not disagree about the duties of a concurring partner. They disagreed only about whether petitioner had adequately performed those duties.

148-154. Thus, petitioner is incorrect in asserting that neither petitioner "nor anyone else in the industry would have expected that the role of the concurring partner meant what the Commission now says it means."[4] Pet. 12.

Finally, as the court of appeals noted (Pet. App. A-7), the Commission had issued several opinions and orders in settled cases prior to 1988 that addressed and explained the responsibility of accountants acting as concurring partners to provide additional assurances of compliance with GAAS and GAAP. Thus, the instant case is not, as petitioner asserts (Pet. 3), the Commission's first decision involving concurring partners. Nor, for that matter, does it represent an attempt by the Commission to promulgate new accounting and auditing standards for concurring partners under the pretense of regulating their professional conduct as accountants.

In sum, petitioner is incorrect in claiming that the Commission suspended him even though he had "complied with [existing] standards." Pet. 28. The Commission based the suspension on its finding that petitioner had gravely departed from those standards.

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[4] This case is therefore readily distinguishable from *In re Carter*, 47 S.E.C. 471 (1981). *Carter* involved the application of Rule 2(e) to attorneys and turned on the Commission's finding that "[t]he ethical and professional responsibilities of lawyers who become aware that their client is engaging in violations of the securities laws" had not been sufficiently established to justify holding "all practicing lawyers * * * to an awareness of generally recognized norms." 47 S.E.C. at 508. Here, in contrast, the relevant professional norms were adequately delineated.

As the court of appeals correctly held, that finding was amply supported by the record in this case.[5]

2. The decision in this case does not conflict with any decision of this Court or of any court of appeals. Petitioner discusses two cases that he claims support his contentions. See Pet. 18-22, discussing *Checkosky* v. *SEC*, 23 F.3d 452 (1994), following remand, 139 F.3d 221 (D.C. Cir. 1998); and *Upton* v. *SEC*, 75 F.3d 92 (2d Cir. 1996). Each of those decisions is irrelevant to petitioner's claims.

In *Checkosky*, the court of appeals ultimately dismissed a Commission disciplinary proceeding against two accountants because it found that, despite the court's prior remand of the case to the Commission for further explanation of the basis for its decision, the Commission failed adequately to explain whether the decision rested on a finding that the accountants had acted recklessly. See 139 F.3d at 227; 23 F.3d at 465-466. In this case, however, the Commission explicitly found that petitioner had acted recklessly, it defended its decision on that basis in the court of appeals, and the court of appeals affirmed the decision on that ground. Pet. App. A-5 to A-6. Hence, *Checkosky* is inapposite.

Petitioner's reliance on *Upton* is similarly misplaced. In *Upton*, the court of appeals affirmed the Commission's construction of one of its rules but held that a securities firm employee who was the respondent in

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[5] Petitioner also says that it is undisputed that he complied with Touche's requirements for concurring partners. See, *e.g.*, Pet. 13. That assertion, however, is irrelevant to this case, because the Commission was not applying Touche's firm policies and did not have occasion to determine whether petitioner complied with them. The lack of dispute about petitioner's claim that he complied with firm policies, then, does not mean that the Commission agrees with his assertion.

that case could not be disciplined under the rule because the employee had complied with the rule's "literal" requirements and did not have notice that the Commission viewed his conduct to be a violation despite such "literal" compliance. See 75 F.3d at 96-98. Petitioner did not comply with the literal terms of a governing rule. Moreover, for the reasons we have stated (see pp. 10-15, *supra*), petitioner had a "reasonable opportunity to know" (*Upton*, 75 F.3d at 98 (quotation marks omitted)) that the Commission could find that his reckless deviations from the applicable professional standards constituted improper professional conduct.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1998

ROBERT D. POTTS,

Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

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1498

QUESTION PRESENTED

Whether Petitioner had fair notice of the standards for concurring review of a public company audit when he performed concurring reviews of audits of Kahler Corporation ("Kahler") in 1989 and 1990, or whether the SEC and the Eighth Circuit retroactively applied standards previously unarticulated and undefined by any authority in sanctioning Petitioner under SEC Rule 2(e)?

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PRELIMINARY STATEMENT

The American Institute of Certified Public Accountants (the "AICPA") submits this brief as *amicus curiae*, pursuant to Rule 37.2 of the Rules of this Court, in support of Petitioner with the written consent of the parties.[1]

INTEREST OF THE AICPA AS *AMICUS CURIAE*

The AICPA is the national organization of the certified public accounting profession, with more than 340,000 members. It seeks to promote high professional standards of practice, and has come to be accepted by the profession, the public, and the SEC as an authoritative source of standards and procedures in its field. In particular, the AICPA develops the standards and procedures that govern the conduct of audits by certified public accountants collectively known as "generally accepted auditing standards" ("GAAS").

The AICPA also established the Division for Firms and its SEC Practice Section ("SECPS") in 1977, as a response to public and congressional concern about the profession's oversight of public company audits. The AICPA, but not the SEC, requires firms whose owners are members of the AICPA and that audit public companies to be members in good standing of the SECPS. The AICPA's SECPS requires member firms to comply with certain guidelines promulgated by the SECPS and overseen by an independent Public Oversight Board.

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1. The letters of consent have been filed with the Clerk of the Court. No counsel for any party to this action authored this brief in whole or in part. No person or entity other than the AICPA, its members, and its counsel made a monetary contribution to the preparation or submission of this brief.

The AICPA's SECPS guidelines promote compliance with an array of prophylactic practices designed to provide heightened assurance that audits will be properly carried out. Those guidelines speak in general terms, and leave much discretion in implementation to individual SECPS member firms. This flexibility was not accidental, but was meant by the AICPA to balance several sets of competing, valid interests. One was to avoid too-rigid a set of standards so that smaller firms would not find it prohibitive to engage in audits of public companies. Another was to balance the need for heightened prophylactic measures with the need to avoid dilution of the undelegable responsibility of the partner-in-charge of the audit for the audit's compliance with GAAS.

In keeping with these goals, the SECPS published guidance as to the attributes of a concurring review, but left it to individual firms to provide concurring reviewers with specific guidelines. A concurring review is not intended to replicate or replace the audit, but only to provide "additional assurance" that the audit complies with GAAS. The SECPS guidelines emphasized that the concurring reviewer did not displace the role of the partner-in-charge:

> The purpose of the concurring review requirement is to provide additional assurance that (1) the financial statements of SEC engagements . . . are in conformity with generally accepted accounting principles or other comprehensive basis of accounting and (2) the firm's report thereon is in accordance with generally accepted auditing standards. Performance of a concurring review does not relieve the partner in charge of the

> engagement from final responsibility for the issuance of the firm's audit report. . . .

AICPA, SECPS, Appendix E (October, 1988). Prior to the publication of the SECPS guidelines, no concurring review was required, or even suggested, for any audit. The only authority that requires a concurring review is the SECPS, which applies only to AICPA members. The SEC itself does not require firms that audit public companies to be AICPA or SECPS members.

The AICPA and its members have a strong interest in this Court's review of the decision below. The decision measured Petitioner's actions in performing a concurring review by standards far beyond those of the SECPS. The only generally applicable guidance was provided by the SECPS, and the SEC has not argued that Petitioner failed to comply with SECPS guidelines, or with his firm's internal compliance standards for a concurring review. In its sanction of Petitioner, the SEC created a standard not previously articulated by the SEC, the AICPA, or Petitioner's firm, and applied it retroactively.

The Eighth Circuit's decision has serious ramifications for the proper implementation of both the SECPS guidelines and GAAS. The retroactive application of newly announced concurring review standards will sow confusion as to the proper role of the concurring reviewer. Concurring reviewers cannot ascertain what the requirements of their role are, and cannot perform their duties without the possibility of running afoul of SEC requirements not yet announced. The result, as concurring reviewers expand their role in an effort to protect themselves from career-destroying SEC sanctions, will be the concurring reviewer's encroachment upon the authority of the partner-in-charge. This will prohibitively raise costs and dilute accountability for the audit report. The decision below is not only erroneous but counterproductive.

In order to avoid unnecessary duplication, the AICPA defers to the Petitioner's recitation of the Statement of the Case.

THE DECISION BELOW

The Eighth Circuit held that Petitioner's conduct in reviewing and "signing off" on Kahler's audits for the years 1988 and 1989 was reckless. (Pet. App. at A-5.) The court further held that Petitioner's due process argument failed because Petitioner had adequate notice of the SEC's standards of professional conduct for concurring reviewers, finding that "the Commission evaluated Pott's conduct in light of the well-established norms of the accounting profession, collectively referred to as GAAP and GAAS." (Pet. App. at A-6, A-7.)

REASONS FOR GRANTING THE WRIT

I. THE ISSUE PRESENTED IS OF GREAT IMPORTANCE TO ACCOUNTING FIRMS PRACTICING BEFORE THE SEC AND TO THEIR CLIENTS.

In 1989 and 1990, when Petitioner conducted his concurring review of the Kahler audits, a concurring review was subject only to the general guidelines provided by the SECPS, and to internal guidelines created by the reviewer's firm. Under GAAS and the SECPS, the partner-in-charge had sole responsibility for ensuring that the audit complies with the requirements of GAAS and for so stating in the audit report, and that responsibility could not be delegated or shared.

In sanctioning Petitioner, the SEC and the Eighth Circuit announced and applied a brand new set of standards for concurring reviewers, expanding their duties to include those of the partner-in-charge. Not only does this violate Petitioner's right to due process, it has a broad impact on accountants and the accounting professions.

Given such retroactive application of new standards, reviewers may only be able to protect themselves from sanctions if they re-do the audit, covering all possible bases for SEC dissatisfaction. The result is not a concurring review as intended by the AICPA, but a second partner-in-charge. This replication of work prohibitively overburdens the concurring reviewers, their firms, their clients who must pay for the redundant work, and those firms whose resources make such an endeavor impractical and are thus foreclosed from auditing public companies.

The retroactive application of new standards may also chill the process by which the AICPA and other private, voluntary organizations set standards for their members. Such standards are carefully crafted by the AICPA and other voluntary organizations for the purpose of improving the services offered by their members. When the SEC alters these standards without notice by adding retroactive content, voluntary standards can become a burden, rather than a benefit, both to members and to their clients. Private organizations may become reluctant to create any new standards when their content and application become unpredictable in the hands of the SEC.

Finally, the decision below undermines the most important single safeguard of the integrity of the audit process — the undiluted authority and responsibility of the CPA partner-in-charge who signs the audit opinion.

II. THE COURT SHOULD REVIEW THE DECISION BELOW AND REQUIRE THE SEC TO APPLY NEWLY ARTICULATED STANDARDS FOR ACCOUNTANTS PROSPECTIVELY, NOT RETROACTIVELY.

The SEC has acknowledged that a professional is entitled to notice of applicable regulatory standards if such standards are to be used as the basis for sanctions:

> [E]lemental notions of fairness dictate that the Commission should not establish new rules of conduct and impose them retroactively upon professionals who acted at the time without reason to believe that their conduct was unethical or improper.

Carter, Securities Act Release No. 17597, Fed. Sec. L. Rep. (CCH) ¶ 82,847 (Feb. 28, 1981), at 84,173; *see Upton v. SEC*, 75 F.3d 92, 96 (2d Cir. 1996) (court cannot defer to the SEC's interpretation of its rules if doing so would penalize an individual who has not received fair notice of a regulatory violation).

The SEC, nevertheless, sanctioned Petitioner based on standards never previously articulated by the AICPA or the SEC, and, in fact, contradicted by the SECPS.

The Eighth Circuit found that Petitioner was on notice of the standards applied by the SEC because GAAS requires that: (a) an auditor's opinion must have a basis in specific evidence; (b) an auditor must maintain an appropriate level of professional skepticism; (c) an auditor who suspects a

material misstatement in the financial report must extend the audit accordingly; and (d) the more important the item, the stronger must be the grounds for the auditor's opinion. (Pet. App. at A-6.) All of this, however, says nothing as to the specific conduct required of a concurring reviewer. It does not define what kind of evidence suffices, what level of skepticism is "appropriate," how far the concurring review must be extended, or how strong grounds for a concurrence must be.[2] Each of these requirements is measured by the role of the accountant in a specific audit, and in 1989 and 1990, the duties of a concurring reviewer were defined only by the SECPS guidelines, which strictly limited the concurring reviewer's role:

> The concurring reviewer's responsibilities should include reading the financial statements and the firm's report thereon and making an objective review of significant accounting, auditing or reporting considerations. *Such review should . . . include discussions with the partner-in-charge of the engagement* and review of selected working papers. *The extent of working paper review is a professional judgment which has to be made by*

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2. The SEC majority more specifically asserted that Petitioner, as concurring reviewer, was required by GAAS to: "probe" and challenge the partner-in-charge as to the veracity of his statements; ask the partner-in-charge for documentary evidence supporting his statements; question a document prepared by a senior manager of the firm verifying a valuation; and conclude that formal audit committee minutes in the Top File were insufficient evidence. (Pet. App. at A-24 - A-30.) GAAS includes no such requirements for concurring reviewers.

> *the reviewer* and will vary with the particular circumstances of each engagement.

AICPA, SECPS, Appendix E (October, 1988) (emphasis added). The SEC has not argued, and the court below has not found, that Petitioner failed to comply with these guidelines. Instead, Petitioner apparently was sanctioned for failing, without basis, to disbelieve the statements of the partner-in-charge — a new requirement imposed by the SEC.

One of the few specific steps the SECPS mandated is "discussions with the partner-in-charge." The misconduct found by the SEC majority consisted of Petitioner's failure to take additional steps after the partner-in-charge had investigated, with Petitioner's supervision, their concerns, and had explained to Petitioner that he was satisfied. The additional steps required by the court below would impose upon Petitioner the responsibility of the partner-in-charge — a transfer of responsibility that was specifically prohibited by the SECPS:

> For the concurring review to be an objective review of material accounting, auditing or reporting issues, the concurring reviewer ordinarily should not assume any of the responsibilities of the partner-in-charge of the engagement. Similarly, the concurring reviewer should not have responsibility for any segment of the engagement.

AICPA, SECPS, Appendix E (October, 1988).

To be sure, if matters arise in the concurring review demonstrating that the concurring reviewer could not accept the judgment of the partner-in-charge, then the concurring reviewer would be obliged to extend the review. Under the SECPS guidelines, the extent of the concurring reviewer's

review of the evidence obtained was explicitly left to his professional judgment in the circumstances, and the general standards applicable to all accountants' services require the accountant to exercise due professional care in performing duties. Barring circumstances indicating that the judgment of the partner-in-charge is impaired, however, the insistence that Petitioner should without basis have obtained audit evidence beyond the assurances of the partner-in-charge or the senior managers of his firm illustrates the imposition, without notice, of the responsibility of the audit engagement team upon the concurring reviewer. Petitioner's duties were those of a concurring reviewer, not a partner-in-charge.

The Eighth Circuit relied on three cases to support its finding that Petitioner was on notice of concurring reviewer duties beyond those stated by the SECPS. None of these was contested, and analysis of them emphasizes the lack of defined standards for a concurring review.

In *Lester Witte & Co.*, Exchange Act Release No. 17,423, ASR No. 285, [1937-1982 ASR Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,307, at 62,865 (Jan. 7, 1981), the SEC did not sanction the concurring reviewer, even though it found the concurring review inadequate. Rather, the SEC sanctioned only the firm and the partner-in-charge, emphasizing that the partner-in-charge "bears responsibility for the audit deficiencies which occurred." *Id.* at 62,865-66. *Lester Witte* contradicts, rather than supports, the assertion that Petitioner's conduct could be measured against any existing standards.

Neither *SEC v. Thornton*, Litigation Release No. 11,263, AAER No. 118, [1982-1987 AAER Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,518 (Oct. 16, 1986), nor *Stephen O. Wade*, Exchange Act Release No. 21,095, AAER No. 32, 30

S.E.C. Docket 972, 1984 WL 53374 (June 25, 1984), offers any standard for the conduct of a concurring reviewer. The cases cited by the Eighth Circuit, as the opinion's parentheticals note, state in general terms that the concurring reviewer's role is to review the audit with the purpose of detecting violations of GAAP and GAAS. These cases, and the Eighth Circuit's review of them, however, shed no light on the question here: To what lengths was a concurring reviewer required to go in seeking to detect violations of GAAP and GAAS? There is no authority in either the professional literature or SEC cases for requiring Petitioner, as a matter of practice, to disbelieve the statements of the partner-in-charge, or to commence an independent investigation of the bases for the audit opinion. Indeed, the cases cited make it clear that the SEC engaged in improper retroactive application of newly-announced standards.

CONCLUSION

For the foregoing reasons, the AICPA respectfully urges this court to grant the Petition to review the decision of the Eighth Circuit Court of Appeals.

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No. 98-1058

In the
Supreme Court of the United States
October Term, 1998

Robert D. Potts,

Petitioner.

v.

Securities and Exchange Commission,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF
APPEALS FOR THE EIGHTH CIRCUIT

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INTRODUCTION

With its decision, the Securities and Exchange Commission (Commission) has effected a sweeping change in the manner by which accounting firms perform audits of publicly held companies. The Commission has dramatically changed the role of the concurring partner, from someone who had a carefully limited role to provide some quality assurance, to someone who must be prepared to reject the assurances of the engagement partner and go behind the evidence assembled by the audit team, *i.e.*, audit the audit. There was nothing in Commission precedent or industry standards that gave the slightest suggestion of this new and expanded role for concurring partners. Because of the profound impact of the Commission's decision on the accounting profession, the American Institute of Certified Public Accountants (AICPA) has filed a brief *amicus curiae* in support of Mr. Potts' petition.

As explained in the initial petition, this case presents pressing constitutional and statutory issues that warrant this Court's review—the due process limits and statutory authority governing the Commission's imposition of livelihood-crippling professional sanctions. The opposition filed by the Commission confirms that the agency is still fundamentally confused about the gravity of imposing professional sanctions and the need for clear standards before imposing such sanctions. Other courts have expressed serious concern about the Commission's confusion and bull-in-a-china-shop approach to professional standards. The Commission weakly states that those decisions are distinguishable, which merely demonstrates that it fails entirely to appreciate the import of judicial decisions stating that it is acting lawlessly in the truest sense of the

word—with little or no regard for the need to adhere to clearly articulated legal standards in an area of profound consequences.

The Commission tries to sidestep the issue through two strategems that merely highlight the need for this Court's review. First, the agency maintains that this case is simply about a fact-specific question of "substantial evidence." The agency thus fails to understand the critically important legal question presented—the nature and content of the legal standards for the Commission's imposition of professional sanctions. Second, the Commission blandly asserts that the professional standard at issue was well-established—an astonishing statement that reveals the agency's insouciance about its devastating professional sanctions. The Commission claims that the professional standard is established by the AICPA's standard, *even though the AICPA itself* vigorously rejects that proposition and even though the agency's punitive sanction flies in the face of the language of the AICPA standard. The Commission claims that its prior decisions set forth what Mr. Potts should have done, merely because those decisions *mention* the term "concurring partner," and fails even to respond to Mr. Potts' explanation that those decisions do not remotely establish the standard said to be violated here.

The Commission's response confirms the importance of this Court's review to clarify the standards governing the Commission's imposition of professional sanctions. This case is a perfect vehicle for addressing this issue, which has generated repeated expressions of judicial concern. The Commission's imposition of professional sanctions is in conflict with the existing professional standard, according to the industry group that promulgated that standard; it is in conflict with the interpretation of Mr. Potts' employer, a

point not disputed by the Commission; it is not supported by prior Commission decisions; and, as the AICPA's *amicus* brief makes clear, the Commission's decision on the merits has profound, real-world consequences for the standards employed by thousands of accountants across the country—a result that is both unwise and beyond the agency's authority.

ARGUMENT

I. Review is Warranted Because the Commission Cannot Articulate a Standard of Conduct That Comports With Due Process.

Before the government can impose punishment it must provide "the person of ordinary intelligence a reasonable opportunity to know what is prohibited, so that he may act accordingly." *Grayned v. City of Rockford*, 408 U.S. 104, 108 (1972). The Commission argues that Mr. Potts knew what was expected of him in 1989 and 1990, when he served as concurring partner of the Kahler audits. According to the Commission, it evaluated Mr. Potts' conduct against well-established standards for accountants, as set forth in Generally Accepted Accounting Principles (GAAP) and Generally Accepted Auditing Standards (GAAS). SEC Brief in Opposition at 11. To flesh out what the AICPA SEC Practice Section guidelines required of Mr. Potts, the Commission claims reliance on the auditing standards of the AICPA, expert testimony and prior Commission precedent. *Id.* On scrutiny, however, these sources fail entirely to support the Commission. Rather, the Commission's reliance on these sources indicates the agency has no idea of the level of clarity needed under its Rule 2(e) to comply with due process.

The guidelines of the AICPA SEC Practice Section are

very general, and the Commission does not dispute that Mr. Potts complied with those guidelines. Likewise, Mr. Potts complied with the more detailed guidelines of his firm.[1] In 1989 and 1990, those guidelines were the sole sources for guidance to Mr. Potts when performing a concurring review. The agency tries to claim that it is "irrelevant" whether the conduct for which it imposed harsh sanctions complied perfectly with the standards of Mr. Potts' employer, one of the leading accounting firms in the nation. *See* SEC Brief in Opposition at 15 n.5. This assertion rings hollow, because at the very least, the policies of Touche, which were consistent with the AICPA's guidelines, must be "relevant" to whether Mr. Potts violated established professional standards.

Recognizing the generality in the AICPA guidelines for concurring partner review, the Commission argues that GAAP and GAAS provided standards of conduct that Mr. Potts could have looked to for guidance. But there is nothing in GAAP or GAAS that even requires a concurring partner review, much less specifically address what an accountant should do when performing such a review. Instead, for concurring partners the Commission imported standards from GAAS that the AICPA intended to apply only to the audit team, which is to be under the exclusive supervision of the engagement partner. The agency's reliance on these auditing standards is dubious and problematic, *see infra* at 9, but even the catch-all duty to exercise due care does not resolve the due process dilemma in which the Commission finds itself.

The obligation to exercise due care is amorphous and

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[1] To be sure, the question whether Touche as a whole properly applied APB-30 is *not* the issue presented, but Mr. Potts wants to point out that he does not agree, as the Commission asserts, that APB-30 was incorrectly applied. He believes, as he has throughout, that Kahler correctly accounted for the University Park hotel as an asset held for sale.

must be defined and enforced in the context of the performance of a known duty. Here, Mr. Potts served as the concurring partner and any due care he was expected to use had to be measured by the known parameters of that role. As the AICPA elaborates in its brief as *amicus*, that organization struck a careful balance in its concurring reviewer guidelines, striving to place sole responsibility for the audit in one person—the engagement partner. The Commission's resort to GAAS is thus doubly flawed, for it subverts the critical role of the engagement partner, while ignoring the due process implications for someone in Mr. Potts' position. This reliance on GAAP and GAAS standards—which are entirely silent on concurring partner review—only demonstrates how little guidance there was to advise Mr. Potts how strenuously he should have challenged the engagement partner during the Kahler audit.

In a patent effort to insulate its decision from review, the agency also claims that the standard was established by expert testimony in this proceeding—a dubious due process proposition itself (particularly in light of the AICPA standard and the interpretation of that standard by Touche), but one that collapses because the expert testimony confirms that there was no clearly established standard. On *direct* examination, Commission expert Donald Moulin explained why he was testifying on behalf of the agency:

> I felt that the profession would be enhanced if there were a clarification of the requirements so that others in the profession would really understand clearly what was intended by the SEC Practice Section rules on concurring review.

(J.A. 459.) This testimony obviously did not address the issue whether the standards for concurring partner review in

1989 and 1990, when the Kahler audit was performed, would have adequately apprised the accountant doing a concurring review what was expected.

The Commission also quotes from Edward Kerans, an expert retained by Mr. Potts. The agency's use of this testimony is misleading in its inference that Mr. Potts failed to meet the standards of care expected of him. On the contrary, Mr. Kerans testified that Mr. Potts:

> did appropriately fulfill his concurring partner responsibilities as outlined in the Touche Ross policies and as required in the guidelines ... specified in the [AICPA's] SEC Practice Section reference manual.

(J.A. 633). To the extent that experts differ, moreover, there is no basis for inferring that the standards of conduct expected of a concurring partner were "well established."

The Commission also argues that it had addressed the role of the concurring partner in prior decisions. This assertion wholly ignores the admission the agency made in its decision, that:

> this matter represents the *first* litigated proceeding to come before us involving an accountant acting *solely* as a concurring partner, ...

(A. 34.) (Emphasis added.) In his opening brief, as well as that of *amicus* AICPA, Mr. Potts also explained how this precedent said nothing about the duty he had assumed. The Commission must agree, for it fails utterly to demonstrate what guidance Mr. Potts could have gleaned from those decisions.

In short, not one of the sources on which the Commission relies here overcomes what Mr. Potts asserted earlier—that

the standard of the AICPA SEC Practice Section, the only applicable industry standard, provided no notice of the standard of conduct that proved to be the basis of the Commission's punitive sanction. Further, Mr. Potts did what he was supposed to do—comply with the applicable standard. Thus, nothing the Commission has said obviates the need for review to establish what level of clarity the agency must establish before it can punish a professional who practices before it.

II. Review is Warranted to Reconcile the Decision Below With That of the Second and District of Columbia Circuits.

The Commission's decision, affirmed by the Eighth Circuit, enunciated new and altogether different standards for concurring partners. It now appears that compliance with the AICPA SEC Practice Section standards, or even more detailed firm standards, is insufficient to avoid a sanction under Commission Rule 2(e). The Commission has transformed the concept of due care when *reviewing* an audit into something entirely different. The concurring partner must now be prepared to audit the audit and subsume critical functions of the engagement partner.

As the Commission did in *Upton v. S.E.C.*, 75 F.3d 92 (2d Cir. 1996), it has used this case to articulate a new rule for a profession. Here, it is what is expected of concurring partners; in *Upton*, it was to clarify how a brokerage firm could meet its minimum capital requirements. The Second Circuit overturned the agency's sanction in *Upton* on the ground that the new rule should be imposed only prospectively. *Id.* at 98 The Commission makes the facile argument that *Upton* is distinguishable because here Mr. Potts

"did not comply with the literal terms of a governing rule." SEC Brief in Opposition at 16. But Mr. Potts in fact complied with the AICPA Practice Section guidelines, a point the Commission has never disputed. The duty of due care, which the Commission said was violated here, could only have been defined in terms of the standards set by the AICPA SEC Practice Section (and those of Touche), which Mr. Potts met. In its retroactive application, the decision below simply cannot be reconciled with *Upton*.

Likewise, the decision in the District of Columbia Circuit reached in *Checkosky v. S.E.C.*, 23 F.3d 452 (D.C. Cir. 1994), *after remand*, 139 F.3d. 221 (D.C. Cir. 1998), conflicts with the decision below. The Commission found that the accountants in *Checkosky* had acted with scienter, 23 F.3d at 481; 139 F.3d at 223, but held as well that mere negligence was sufficient to discipline accountants, 23 F.3d. at 458, 475; 139 F.3d at 223-24. The failure to specify the level of culpability that bedeviled the agency in *Checkosky* exists here, for Mr. Potts was likewise forced to defend charges of improper professional conduct without knowing what was the minimum level of culpability sufficient to justify Rule 2(e) punishment.

Equally significant in *Checkosky* was the Commission's continued failure to justify its differential treatment of accountants from attorneys when administering Rule 2(e). *See* 23 F.3d at 485. In its decision *In re Carter*, 47 S.E.C. 471 (1981), the Commission acted prospectively, because it recognized that the standards the attorneys looked to were general and required the exercise of professional judgment. That is equally the case here. The agency tries to distinguish *Carter* on the ground the professional norms there were not adequately established. SEC Brief in Opposition at 14 n.4. But attorneys, like accountants, must exercise due care in

performing their duties. Conversely, accountants, like attorneys, must exercise professional judgment when performing an audit. Review is thus warranted to reconcile the differing results in the courts below.

III. The Decision Below Effects a Sweeping Change in Accounting Practices.

The Commission conceded in its decision that this case was the first instance in which it had addressed the conduct expected of a concurring partner when serving solely in that capacity. While it had mentioned that term in a few other decisions, the Commission implicitly conceded that those decisions offered no assistance to the accountant seeking to learn what was expected or potentially sanctionable conduct. This case is intended to make new law and set new standards for auditing practices.

As the AICPA sets forth in its brief *amicus curiae*, the changes the Commission has effected are profound for the many firms and thousands of accountants who audit publicly held companies. In its guidelines the AICPA requirement of a concurring review struck a crucial balance between quality assurance, primary audit responsibility and cost, a balance the Commission now wholly disregards. Lacking express authority to regulate auditory standards, the Commission has used this case to articulate, ad hoc, new auditing standards. The Commission's arrogation of AICPA auditing standards to a use for which they were never intended threatens the useful public-private cooperation that has existed between the Commission and the AICPA. *See* Brief of AICPA *amicus curiae* at 5. Thus, there is an overriding public interest for this Court to address the manner in which the Commission has elected to exercise that authority in this case.

CONCLUSION

For the foregoing reasons and those advanced earlier, Mr. Potts requests that the Court grant the petition for certiorari to review the decision of the Eighth Circuit in this case.

Dated: April 9, 1999

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